

MINISTRY OF FINANCE

FLASH REPORT

**on the main features of economic and financial processes
based on the data of January-December 2003 and
January 2004**

Budapest, 17 March 2004

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TABLES

Flash report

on the main features of economic and financial processes¹

The analyses of the individual fields of economy have been prepared on the basis of the most recent data available. With the exception of consumption (in relation to which only data of the first-third quarters of 2003 have been published) the data of all major processes are known for the whole year of 2003. Regarding industrial output, exports and imports, inflation, labour market movements, the available data cover January 2004, and concerning the budget, the available data relate to January and February 2004.

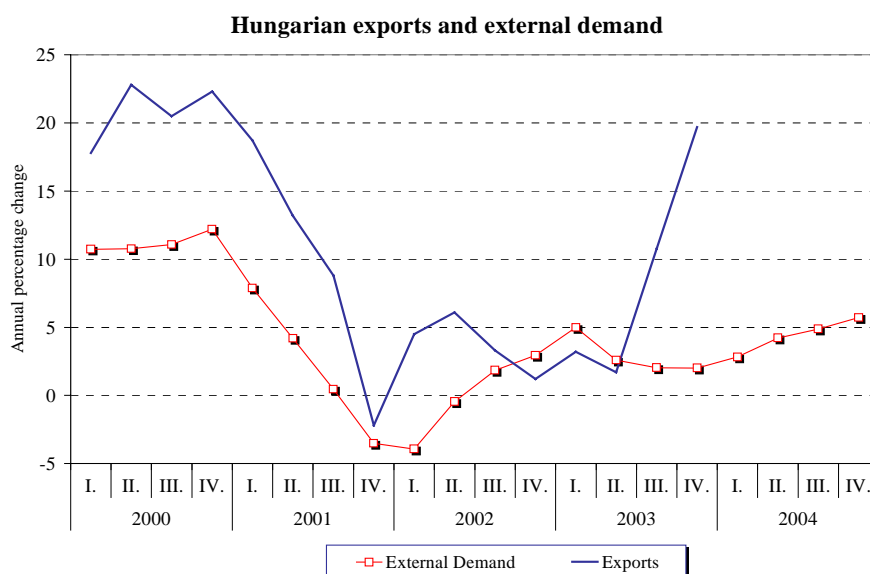
1. External demand

Following the lowest point in 2003, demand has begun to increase slowly in our **export markets**². This increase in the EU countries was weaker than expected at the beginning of the year, but the import demand of CEE countries began to grow rapidly. The slow increase of external demand in 2004, estimated on the basis of OECD 2003 autumn projections has not been questioned on the basis of the performance of the period to date. Assuming favourable changes in the external markets of the euro zone, the ECB projections made at the beginning of the year indicate gradual growth. However, there seems to be general uncertainty with regard to the durability, intensity and extension of the boom, which is related to the following main reasons: (1) it is doubtful to what extent the USA growth can be maintained, with a high current account deficit; (2) the impact of American growth on Europe does not seem to be too intensive yet. The stronger euro reduces the growth of exports, encouraged by the general boom, while the increase of domestic demand may be limited by budget corrections and precautionary savings caused by social reforms. (3) The growth outlook is still relatively favourable in Asian countries, where the demand of the Chinese market has become increasingly important during the last few years. However, the dominant effect of USA is still effective, and strong dependence can remain there, too.

Following the lowest point in 2003, demand has begun to increase slowly in our export markets. Growth will continue in 2004, but its intensity, extension and durability are uncertain

¹ The monthly breakdown of the most important actual data are contained in Tables 1 and 2, the macro prognosis is contained in Table 3, while the world economic growth trends are shown in Table No. 4.

² Export market = import demand of the main 15 export partners. The calculations have been prepared on the basis of OECD 2003 autumn projections.

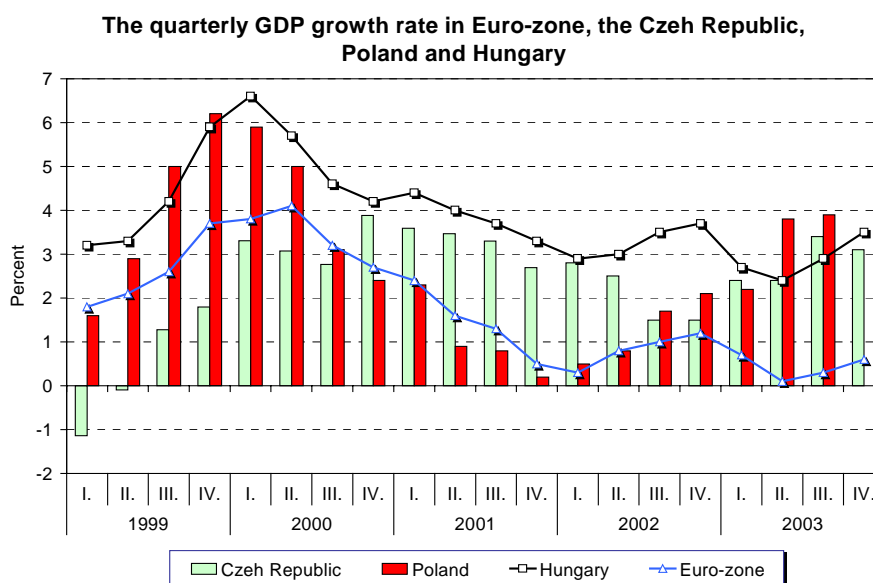


2. Growth

Since the second quarter of 2003 the performance of the Hungarian economy has been continuously accelerating. The growth rate of the gross domestic product increased by 3.5 % in the fourth quarter, exceeding the analysts' expectations, and the growth rate in the whole 2003 was 2.9 %.

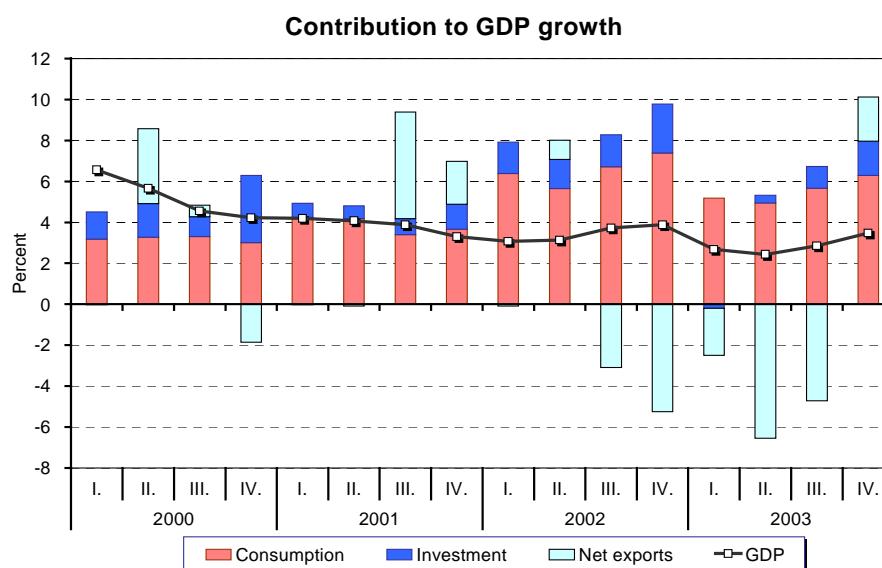
Accelerating economy

The economic upswing was the result of favourable changes in external market conditions and a turn of the economic policy. According to preliminary data, the GDP growth of Hungary's main trading partners, especially in the euro zone, has been gradually accelerated since spring 2003, and the performance of the German economy, which is extremely important for Hungary, stagnated in the last quarter following an earlier decline. Although among the countries of the region, Poland has been growing faster than Hungary recently on the basis of a weaker performance base of the previous years, in international comparison, the growth of the Hungarian economy is still considered high.



In the second half of 2003 the economic structure of the previous quarters, which was unhealthy for sustainable growth, took a favourable turn. A remarkable improvement in the structure of GDP, including the structure of investments clearly indicates that the Hungarian economy recovered the export and investment driven growth path, characterized the former years.

Investment and export driven growth



In accordance with the significant wage outflow of and declining savings throughout the last year, household consumption increased by nearly 8 %. In the second half of the year, the growth rate slightly accelerated in relation to the additional benefits extended in the last quarter and VAT changes introduced in 2004. This can be reflected in the increasing dynamism of retail trade in the last few months of the year.

Consumption remained dynamic throughout 2003

The consumption/income ratio, which is high for the balance, cannot be maintained on a long-term basis, therefore from 2004, the Government

will apply a strict income policy in order to turn around this unfavourable process. In relation to this, in 2004 much slower consumption increase and higher household savings are expected. There is a favourable sign already, according to which based on preliminary January data, household deposit stock increased twice as fast as loan stock.

After a moderate growth in the first half of the year, investments in the national economy increased significantly in the second half of the year. The unfavourable investment structure, prevailing in the previous quarters was replaced with a structure driven by corporate investments as a result of increasing external demand. The investment activity of the corporate sector, including the manufacturing investments, which are absolutely necessary for the acceleration of economic growth, have risen significantly. The investments of the household sector decelerated in the first half of the year, but there was an increase in this sector in the second half of the year, too. At the same time, the investments of general government declined compared to the significant performance of the base year.

Dynamic investment activity in the corporate sector

Based on a further increase in investment activities of the corporate sector and a short-term increase in housing construction, this year a 6-8 % growth rate can be projected.

The volume of investments will accelerate further in 2004

Following a moderate increase in the first half of the year, there was a remarkable increase in the export of goods and services starting in July. The increase of volume was close to 20 % in the fourth quarter. This was significantly due to increasing production capacities, resulting from the investments made in manufacturing, weaker HUF exchange rates, and a low base, too.

Dynamic export sales

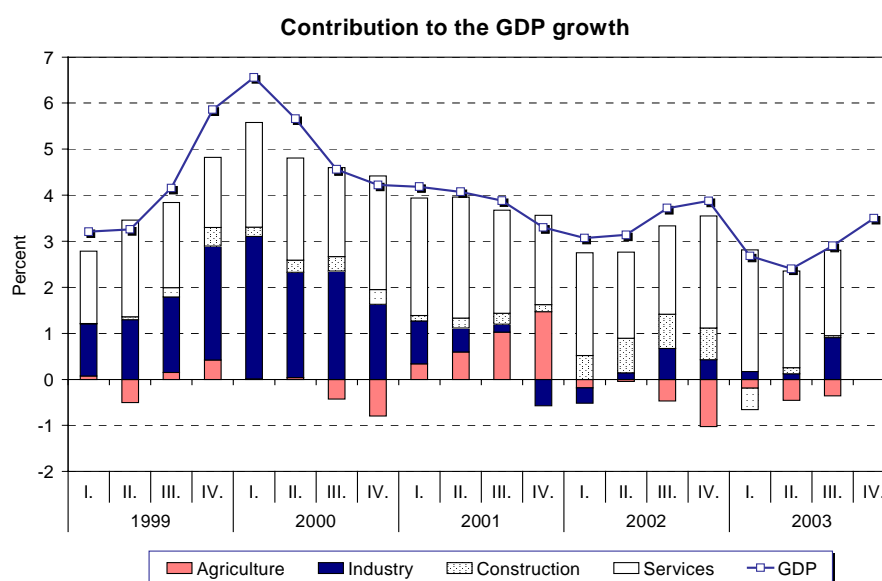
Last year, imports were more than 10 % higher than in the previous year. The high import increase is still related to an increase in imports for consumption purposes (primarily vehicle import) and machinery investments boosting the output of manufacturing, but there was also a significant increase in the import of fuels, electric energy. In the last quarter, the dynamism of import remained high, but after nearly 18 months, the growth rate of export was higher than that of imports. Thus, in the fourth quarter, net exports contributed to the GDP growth by more than 2 %. The same indicator was still -4.5 % in the first nine months of the year.

Continuing dynamic increase in imports

There was a favourable change in the production structure of GDP, too. The value added of industry increased strongly in the last two quarters, and especially the added value of manufacturing grew a lot. There was also considerable growth in the service sectors, although dynamism slowed down quarter by quarter. Mainly due to unfavourable weather, agricultural production did not even reach the low level prevailing in 2002. Following a significant decline in the first quarter, the construction industry was able to increase its already outstandingly high performance

A significant increase in the value added of manufacturing has contributed to the acceleration of GDP

observed in the base year.



For this year we expect further improvement in the favourable economic structure, involving a much higher productivity increase than the rate of consumption increase. On the basis of projections of international organisations, the growth rate of the strongly open Hungarian economy can be around 3.5 % as a result of the West European upswing observed in the whole 2004.

3.3-3.5 % growth is projected for the whole 2004

2.1 Wages and salaries

According to the CSO figures, the gross nominal average wages of full-time employees of the national economy in 2003 increased 12% slower than in 2002. Wages increased by 8.9 % in the business sector in enterprises with at least 5 employees, while in the public sector, the increase was 17.5 %. At the same time, the annual growth rate of net wages was 3.4 % higher in the business sector as a result of a lower tax burden, while it was 0.5 percentage point higher in the public sector. The increase of labour income was 0.2 percentage point higher than the gross wage index in 2003, which was most probably due to an increase of tax free meal contribution.

The growth rate of gross wages slowed down in 2003

Monthly average earnings, 2002-2003
the previous year = 100 (in per cent)

	Total		Business sector		Government	
	2002	2003	2002	2003	2002	2003
Gross earnings	118,3	112,0	113,3	108,9	129,2	117,5
Net earnings	119,6	114,3	116,0	112,3	127,5	118,0
Real earnings	113,6	109,2	110,2	107,3	121,1	112,7
Number of employees	100,1	101,0	99,3	100,2	101,5	102,3

There was a dual impact on wages in 2003, reflected in a slower growth dynamism of gross indices (observed especially in September) and strong deceleration of the growth rate of net indices from September. The reason of both impacts goes back to September 2002, when wages of public servants were increased after several years of waiting. In addition, the tax credit related to the personal income tax also changed as a result of a favourable reform affecting those with low income. The monthly HUF 50,000 minimum gross wages were not increased, but the net annual wages, i.e. the take-home pay went up by slightly more than 10 %. In international comparison, the gross minimum wages of Hungary are lower than the minimum wages prevailing in certain countries of the European Union, but it is a higher than the in candidate countries, except Slovenia and Malta.

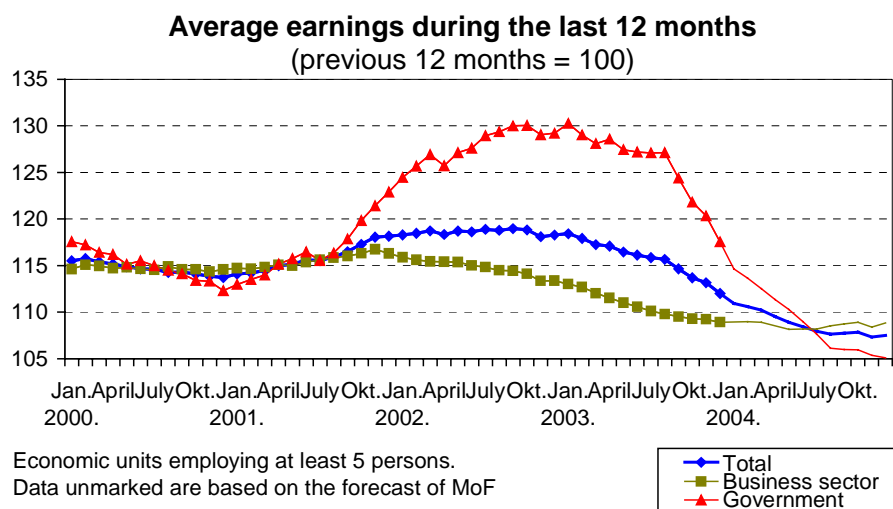
Monthly minimum wages, 2000–2003

Ország	2000	2001	2002	2003
Belgium	1096	1118	1163	1163
Ireland	945	945	1009	1073
Portugal	371	390	406	416
Hungary	98	156	202	212
Czech Republic	--	--	--	199
Estonia	--	--	118	138
Lithuania	--	120	120	125
Latvia	--	--	101	116
Poland	--	196	212	201
Slovak Republic	--	--	114	133
Malta	--	--	552	535
Slovenia	--	--	--	451

In 2003, the monthly average wage growth indices of the business sector varied between 7 % and 10 %. The annual increase was 8.9 %, with a big spread between various sectors. The most dynamic increase took place in the financial sector (13.7 %), while the slowest gross rate was in the manufacturing, not elsewhere classified (2.2 %). The net wage increase in the business sector varied between 9.4-15.4 % (manufacturing of other non-metallic mineral products and forestry). The tax exemption of minimum wages improved the real wage position of employees working in sectors paying low wages even without a major increase in gross wages (for example, textile, clothing, shoe industry). The 4.5 % wage increase proposal of the National Interest Reconciliation Council for 2003 related to net real wages because of the different changes in personal income tax liabilities in different wage categories. Thus, according to the calculations made during the compilation of the prognosis, on average 4-5 % gross increase would also have been sufficient for satisfying the proposal. This objective was exceeded due to several reasons:

- Much lower inflation than expected by the participants in the market;
- The corporate estimate of net wages was very complex, many employers almost ignored the changes in the tax system with differentiated effects, and increased gross wages above inflation in accordance with the recommendation of the National Interest Reconciliation Council;
- The wage increase in the public sector introduced in September 2002 also drove wage increases of companies up.

In 2003, the gross wage increase in the business sector was around 9 %



During the year, several wage increases took place in the public sector. The wage increase of civil servants, which started in July 2001 was concluded in July 2003. The wages of judges and prosecutors were increased in two steps, in July and November, too. However, in addition to those, the dominant factor of the increase in 2003 was the wage increase of public employees, introduced in September 2002. As a result of these increases, on average, the wages of public sector employees reached 83% of business sector employees working in comparable jobs. Earlier this ratio was between 60-65 %.

Significantly slower pace of wage increase in the public sector in 2003

The growth rate of net wages in the national economy slowed down from September. It was a typical feature of the first eight months of 2003 that the gap between the growth rate of gross and net wages widened to the advantage of net wages as a result of the tax credit increased on 1 September 2002. In accordance with expectations, in September this difference turned for the benefit of gross wages, thus net dynamism slowed down more than gross wages. Despite this, in 2003, the net wage indices were higher than gross wages in all branches of the business sector.

Strong deceleration in net wage increase in the fourth quarter

In the public sector, the half percentage point difference between gross and net wages, for the benefit of net wages, was not as clear in all public sector branches as in the business sector, because the 2002 increase, mentioned earlier was so significant that many employees lost the opportunity for tax credit and their annual income moved into the highest tax bracket. Thus, in education and human and health services, the net wage increase was 1-2 percentage points lower than the gross increase.

In 2004, the growth rate of wages will be around 7.5 % according to our projection. The increase will be higher in the business sector and lower in budgetary institutions. From its constraint driven, ill-managed real wage recommendation made in 2003, the National Interest Reconciliation Council returned to gross wages, and proposed 7-8 % gross wage increase for 2004. On the basis of the experience of previous years, it can be concluded that the wage increase in the business sector is usually higher

In 2004, we expect 7-8% gross average wage increase in the national economy

than the top edge of the proposal. In accordance with our projection, there is a good chance that it will not happen this year. For this reason, it is favourable that the gross minimum wages are increased by 6 % (the minimum wages do not involve any personal income tax liability still), but a contrary factor is that, against the events of the last two years, the growth rate of gross wages will be slightly higher than that of net wages, but the difference is still below 1 percentage point.

2.2 Employees and unemployed

According to CSO institutional statistics in 2003, the number of employees increased by 1 percentage point in enterprises employed at least five employees, and in budgetary and social security institutions. Within the overall increase, the number of employees went up by 0.2 % in the business sector, and 2.3 % in the public sector. At the beginning of the year, the number of employees in the business sector dropped by half a percentage, and from August, it increased by 0.7 %. During the same period, the number of employees working in public institutions increased by 3 %, sometimes even 4 % at the beginning of the year, but this increase fell back to less than 3 % in the second half of the year, and it even declined in the last two months (in December it was 1.1 % lower than in December 2002).

One percent increase in the number of employees in 2003

The following favourable signs can be observed in the 2003 employment statistics:

- Increase in the number of employees;
- Practically stagnating unemployment rate;
- Significant increase in the labour market activity of women;
- Increase in the number of economically active persons.

In the age category between 15-64 years, the number of economically active persons increased by 1.3 % in 2003, while the number of unemployed went up by 2.5 %. In the above age group, the number of employees increased by 1.2 % during the same period. Thus, there was a nearly 1 percentage point increase in the economic activity rate. Within that, the men's index improved by 0.5 percentage point, and that of the women by 1.3 percentage points. The rate increased differently between the two sexes due to an increase in the number of employees in public administration jobs dominated by women, and an increase of the retirement age of women in 2003.

Increase in the participating rate in 2003

Participation rate of the population aged 15-64 (in per cent)

Years	Total	Male	Female
1998	58,2	65,9	50,8
1999	59,6	67,3	52,2
2000	59,9	67,5	52,6
2001	59,6	67,2	52,4
2002	59,7	67,1	52,7

2002	59,7	67,1	52,7
2003	60,6	67,6	53,9

Despite the fact that the overall employment rate and the employment rate of the age group of 15-64 years increased from 56.1 % in 2000 to 57 % in 2003, the employment indicators of Hungary are still unfavourable in international comparison. This labour market indicator is closest to the southern European countries (Greece, Italy, Spain). One of the reasons for that is that there are many women of working age among the people of working age who are inactive due to disability pension. Another reason is that among young people, more women study, therefore they also reduce the number of the employees.

**Employment rate of the population aged 15-64, 2001-2003
(in per cent)**

Country	2001	2002	2003
Belgium	60,9	60,7	--
Germany	66,6	66,4	--
Greece	55,3	56,3	57,5
Spain	57,4	58,3	59,4
EU-15	66,3	66,4	--
Hungary	56,1	56,2	57,0

In order to compare our annual analysis of labour market movements to international statistics, the analysis has been prepared for the age category of 15-64 years. However, for details we rely on CSO's monthly labour statistics applicable to the age category of 15-74 years. There are no significant differences between the two categorisations. In 2003, the 5.9 % unemployment rate of the age category of 15-74 years was just 0.1 percentage point higher than the 2002 average. The dynamism of the unemployment rate gradually declined from the beginning of the year, and the quarterly indices were the following: 6.4 %, 5.8 %, 5.7 % and 5.5%. Within that the unemployment rate of young people (aged between 15-24) was 12.9 % in 2003. This increases year by year, which is still favourable in international comparison, but the proportion of young people among the unemployed is high. It is related to the low number of reported part-time jobs, fulfilled parallel with studies.

*5.9 % unemployment
rate in 2003*

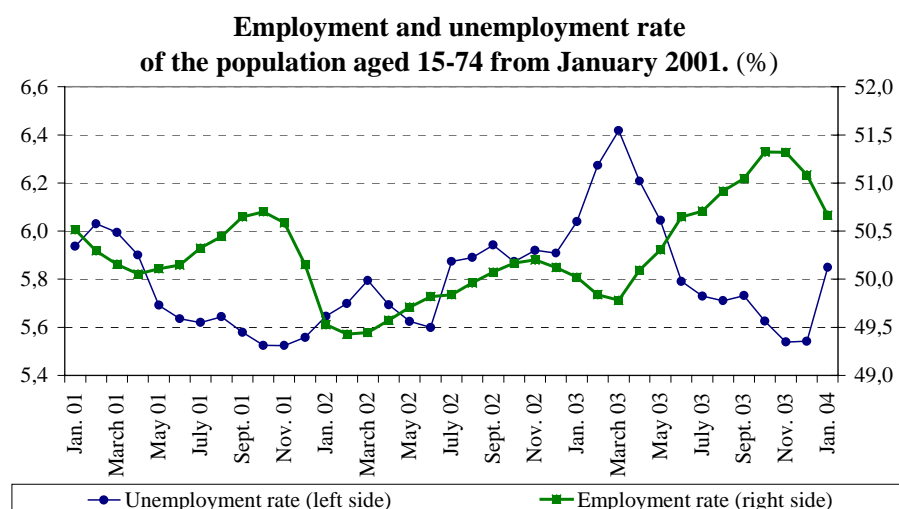
**Unemployment rate of the population aged
15-64 and 15-24, 2001-2003
(in per cent)**

Country	2001		2002		2003	
	15-64	15-24	15-64	15-24	15-64	15-24
Belgium	5,5	14,4	6,1	14,4	--	--
Germany	7,4	7,3	8,1	8,8	--	--

Germany	7,4	7,3	8,1	8,8	--	--
Greece	10,4	28,2	9,8	26,4	9,1	25,5
Spain	10,3	20,6	11,1	21,4	11,0	22,3
EU-15	6,7	12,1	7,1	12,9	--	--
Hungary	5,7	10,7	5,6	11,4	5,8	12,9

On the basis of the CSO labour survey of the population during the period from November to January on average 3,918,0000 employed were surveyed from the age category of 15-74 years, nearly 38,000 employed more than one year before. The unemployment rate of the same period was 5.8 %, which increased for seasonal reasons compared to the data of the previous period, but it was still 0.2 percentage point lower than the figure prevailing one year before.

In January 2004 the unemployment rate is lower than in 2003



In 2004, we estimate an unemployment rate of around 6 %. The number of employed will stagnate at the national level, because due to the slow reaction of the employment structure those who lose their jobs as a result of redundancies introduced in the public sector will not be able to find a job in the business sector immediately even in a booming international economic situation.

In 2004, 6 % unemployment rate and stagnating employment are projected

2.3 Consumption, retail trade

According to the retrospectively corrected data of the latest national accounts published by CSO at the end of December in the third quarter of 2003, the increase of **household consumption** accelerated, so it was high throughout the whole first-third quarters (7.6 %):

High consumption increase rate

Household consumption in 2003

(Index: corresponding period of previous year = 100)

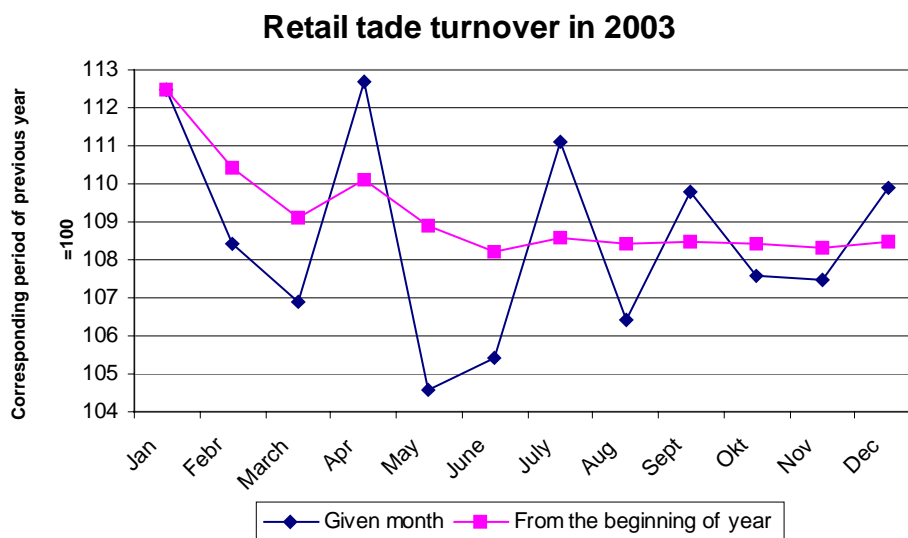
	Q 1	Q 2	Q 3	Q 1-3
Consumption expenditure	108,6	108,0	109,7	108,8
Transfer in kind	101,5	103,4	102,0	102,3
Total	107,2	107,1	108,3	107,6

The considerable dynamism of consumption expenditure (primarily household purchases) stemmed from fast increase of income, as well as reduction of savings. The consumption data of the fourth quarter are published by CSO at the beginning of April, therefore we can only make an estimate for the whole year on the basis of the retail trade turnover.

The volume of the **retail trade** turnover continued to increase fast in the fourth quarter, too, especially in December, which was also due to the extraordinary payments made at the end of the year (53rd week pension, retrospective pension supplement, widow pension increase, child care income supplement). The sales volume without vehicle and fuel trade, adjusted for workdays, increased by 9.4 % in the fourth quarter, and 8.8 % in the whole year compared to the same periods of the previous year. The increase of turnover of non-food products was higher than the dynamism of food and food-type mixed retail sales throughout the whole year.

The growth rate of the turnover of industrial articles was higher than that of foodstuffs

The volume of total retail turnover without adjustments was 8.5 % higher last year than in the previous year:



The price index of retail trade was significantly lower in 2003 (101.7 %) than the consumer price index (104.7 %). The difference was caused by the differing structure, because the price index of services, household

energy, restaurant meals, not included in the retail trade, was higher than the average.

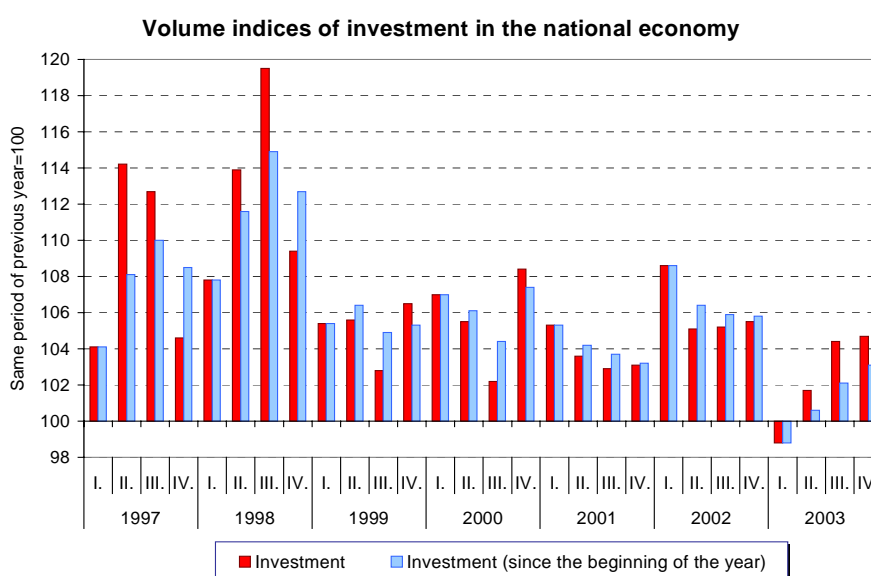
We do not have any actual data for 2004 yet. According to our prognosis, the growth rate of real income will reduce significantly compared to 2003, thus the dynamism of consumption volume will be significantly lower than it was last year.

Dynamism of consumption will fall this year

2.4 Investments

On the basis of preliminary calculations, the volume of investments in the national economy increased by 3.1 %. Following a decline observed in the first quarter, the investment activities gradually improved quarter by quarter reaching 4.7 % between October and December.

Accelerating investment activities

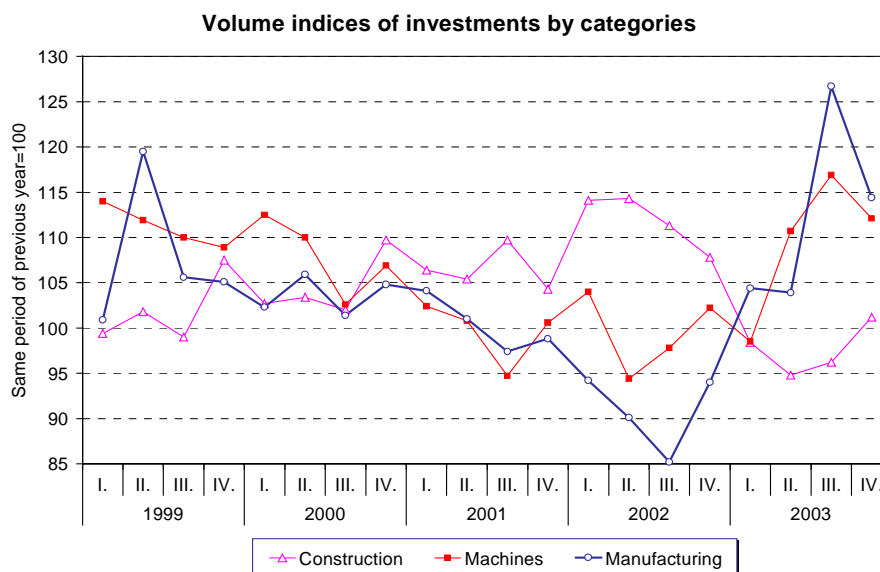


From the second half of 2003, the increase in capital investment activities involved an improvement of the former unfavourable structure. Machines investments increased significantly from the second quarter, involving a slightly more than 12 % increase at an annual level. Following a decline in the first three quarters, construction investments went up by 1.2 % in the last quarter, primarily due to the dwelling construction boom.

Improving investment structure

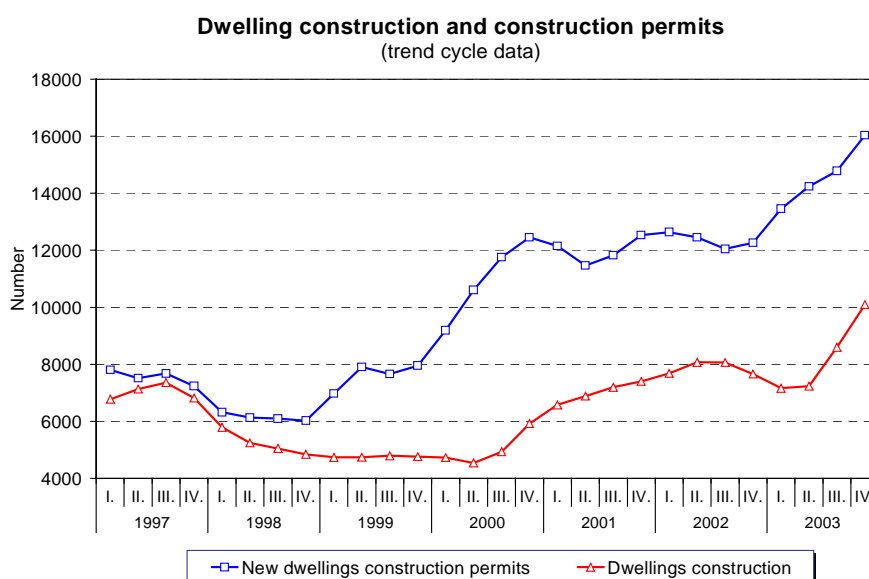
The dynamism of investments in manufacturing, absolutely necessary for the acceleration of economic growth, declined slightly in the last quarter following an outstanding performance observed in the third quarter, but the growth rate was still significant. There was a dynamic increase throughout the whole year of 2003 in real estate, containing also housing investments, which represent more than 25 % of the investments. The increase registered in agriculture was also significantly higher than the average. However, there was nearly 10 % decline in investment activities in such important sectors of the national economy, as transport, storage and communications, which was mainly due to a decline in road construction. The capital investment activities of public administration decreased, too (-25 %).

Strong investment increase in manufacturing



In 2003, the number of dwellings put to use was 12.8 % higher and the number of construction permits issued was 21.5 % higher than the figures registered in 2002. It was a favourable turn that the number of dwellings in the last quarter of the year increased significantly, by 28 %, compared to the nearly 9 % decline in the first half of the year. Following the 15 % increase observed in the first nine months, 39 % more new construction permits were issued than one year before. Concerning the number of issued permits, no such high figures were registered since 1986, and concerning the figure of dwellings put to use have not been so high since 1991. On the basis of the new construction permits issued in 2003, it can be assumed that the dwelling construction dynamism will be maintained until the second half of 2005. Even so the investments of the household sector may increase similarly in 2004 as they did in 2003.

Housing construction boom



According to our calculations this year investments in the national

In 2004, the volume of

economy will increase by 6–8 %, involving further improvement in the structure. This increase is primarily the result of the investments of the corporate sector related to improved export sales outlook and increasing capacity utilisation, housing and motorway construction.

investments may increase to 6–8 %

The increase of corporate investments can slow down slightly, if the currently prevailing high real interest rates remain in effect for a long time. This stimulates multinational companies with international money and capital market relations to take loans from abroad, which will increase the indebtedness of the country. However, Hungarian small and medium-sized enterprises, which do not have such relations, may postpone their capital investments because of the high cost of capital.

2.5 Foreign trade

The acceleration of export and import of goods, which started in July, continued throughout the last months of the year, too, and the foreign trade balance deficit started to decline from October. The export increase, which exceeded that of the import in the fourth quarter, and a strong increase in industrial production clearly indicate an improvement in the economy. The fast increase of investments in the manufacturing industry in the second half of the year indicates further export and economic growth in 2004, but the extent and durability of growth will be determined by external demand and capital investments.

Strong increase in export in the second half of the year indicates economic growth

	Growth in volume as compared to base period, per cent		Difference between export-import growth level	Trade balance of goods (m EUR)	Change in trade balance as compared to the same period of last year (m EUR)
	Export	Import			
Q1	2,8	4,2	-1,5	-911	-160
Q2	1,0	8,7	-7,7	-1297	-741
<i>First half</i>	<i>1,9</i>	<i>6,5</i>	<i>-4,7</i>	<i>-2208</i>	<i>-901</i>
Q3	13,0	13,8	-0,9	-1071	-271
Q4	18,0	12,8	5,2	-983	335
<i>Second half</i>	<i>15,6</i>	<i>13,4</i>	<i>2,2</i>	<i>-2053</i>	<i>64</i>
Total	8,8	10,1	-1,3	-4262	-838
in which:					
general zone	6,7	7,0	-0,3	-9501	-320
custom free zone	11,3	18,3	-7,0	5240	-518

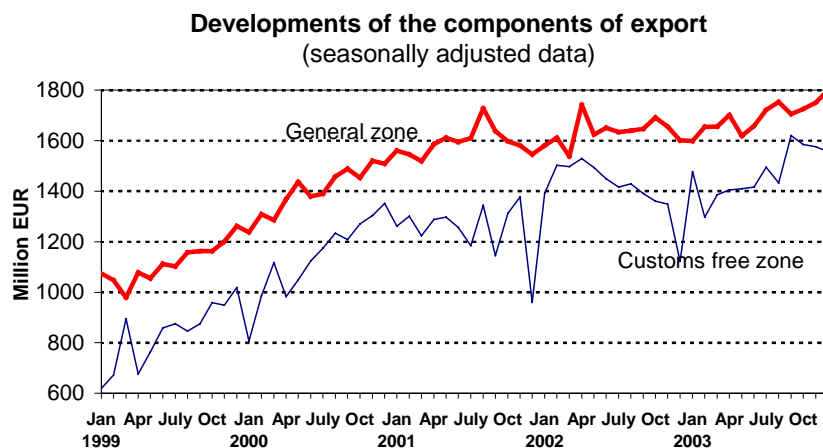
In 2003, export amounted to EUR 38 billion, while import totalled up to EUR 42.3 billion. This was a 4.1 % and 5.8 % respective increase since 2002. (In HUF export went up by 8.4 %, and import grew by 10.2 %.) In volume exports increase by 8.8 %, and imports by 10.1 %.

In the first half of last year (compared to the high base), **export** declined in EUR, but its volume increased by approximately 2 %. With the

The increase of export accelerated in the last

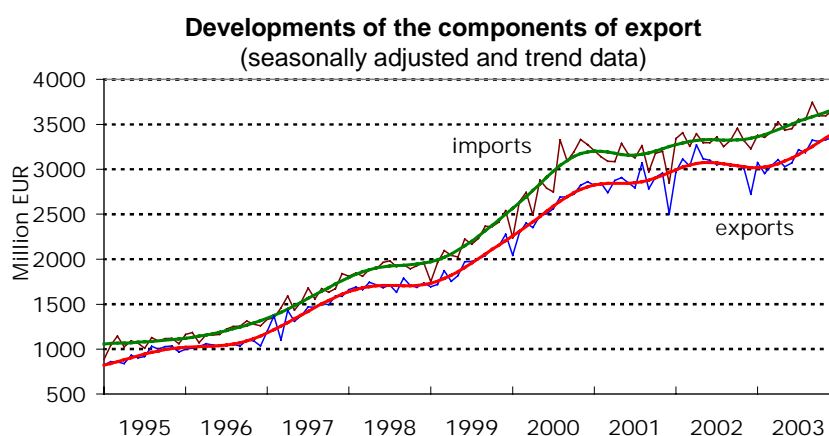
exception of the decline in the second quarter, the export of general zone companies increased relatively evenly, while the export of custom free zone companies declined strongly until August, followed by a spectacular increase (30 % in EUR in December), as a result of which the export volume grew significantly in the fourth quarter of the year (18 %).

quarter of the year, and the export of customs free zone companies also dynamised



The growth rate of **import** reached the highest level in the third quarter, parallel with the start of capital investments, and increased again after a temporary moderate growth level in October. The negative pace difference between export and import growth (for the benefit of imports) reduced from July, and turned into a positive figure in the fourth quarter, i.e. foreign trade made a positive contribution to the growth of the economy.

Foreign trade contributed positively to the GDP growth in the fourth quarter



Concerning the **structure** of export of goods, the export increase was dominated by a more than 13 % increase in machine exports (EUR 5 %), involving primarily the export of electronic and communication products (audio recording and playing devices, mobile phones, etc.). Although the export of manufactured goods declined (as a base effect, and termination of video game and IBM exports) but the pace of decline slowed down month-by-month (without the base effect, a growth rate of 17 % in EUR and 20 % in volume was recorded which was higher than that in machinery). The export of industrial products increased by 9 % in 2003.

The biggest increase was observed in the export of machines

Regarding imports, in addition to the volume and price increase of energy sources and import of consumer products (personal motor vehicles and medical drugs), the 12 % volume increase in machine import for capital investment and production purposes (representing the basis of stock and former export growth) started to dominate more and more. (According to the capital investment statistics, machine investments increased by 16.9 % in the third quarter, and 12.4 % in the fourth quarter.)

Capital investment and export increase plays a bigger role in the increase of imports

Regarding **country groups**, there was also a favourable change in export in the second half of the year. As compared to the former 2-3 % rise the volume of Hungarian exports increased by 8-10 % to developed and EU countries between July and December, as a result of a strong increase in machine export (annually our export increased by approximately 6 % to the same countries). The volume of Hungarian exports to Eastern European countries increased most dynamically, by approximately 20 %, while the pace of increase was 16 % towards developing countries. Regarding imports, the machine import from developed countries (for export purposes) increased most significantly (20 % in volume); import from developed and EU countries increased by 7 and 6 %, respectively.

The share of East European countries increased in exports, from the second half of the year, exports to EU countries accelerated, too, and the share of these countries increased in the last months of the year, too

The **deficit of trade of goods** was EUR 4.3 billion, which was EUR 0.8 billion worse than in the base period. The increase of deficit slowed down strongly from July, and the balance improved by EUR 335 million in the fourth quarter of the year. The annual balance deteriorated due to a decline in the sufficit towards developed countries, including the EU countries, and an increase in the deficit towards the developing countries.

The balance was the result of the elimination of the sufficit towards the developed region and increase of deficit towards developing countries

In January 2004, the export volume increased more than that of the import, by approximately 17 %, while import increased by approximately 12 %. In EUR export went up by 10.2 %, and import declined by 5.6 %. The deficit of trade of goods dropped by more than EUR 110 million, and as a result of an increase of the sufficit towards developed countries, which started in the fourth quarter of 2003. The dynamic increase of both export and import was dominated by the more than 20 % volume increase in the turnover of products of manufactory.

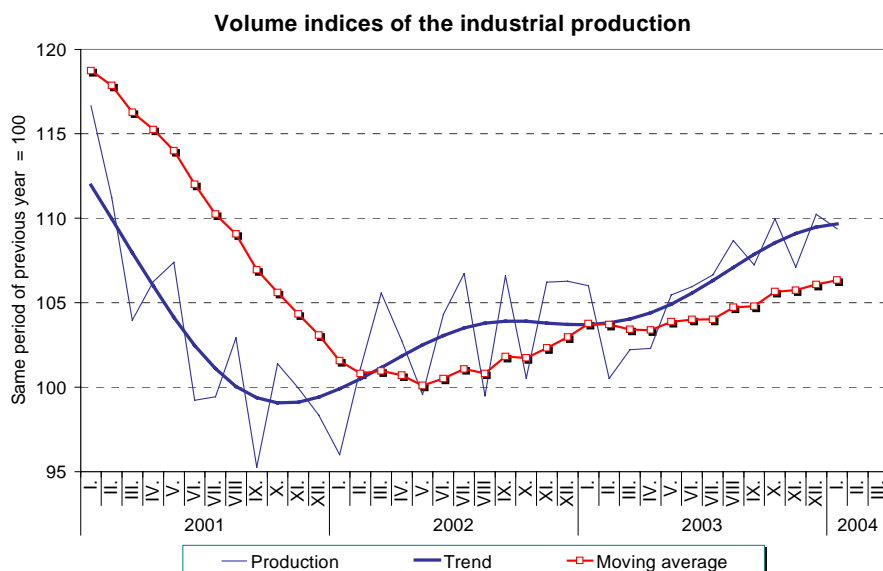
At the beginning of 2004, dynamic export increase continued, together with a decrease in goods turnover deficit

In the first half of 2004, the dynamic increase of exports will continue assuming an increase in external demand and capital investments. In the second half of the year, the growth rate will fall back slightly compared to the high base. In summary, the export increase is expected to be close to the figure prevailing in 2003, or it will be even slightly higher. Because of a slower increase in household consumption, imports will increase less, while the deficit of goods turnover will remain similar to that of 2003.

2.6 Production

On the basis of preliminary CSO data, the growth of industrial production has not been broken: compared to the previous January, in January 2004 production increased by 7.2 %.

Industrial production increased by more than 7 % in January



Industrial output expanded dynamically, quarter-by-quarter, in 2003, involving a total increase of 6.4 %. The production increase was encouraged by exports, while domestic sales hardly increased.

Industrial production increased by 10 % in the fourth quarter

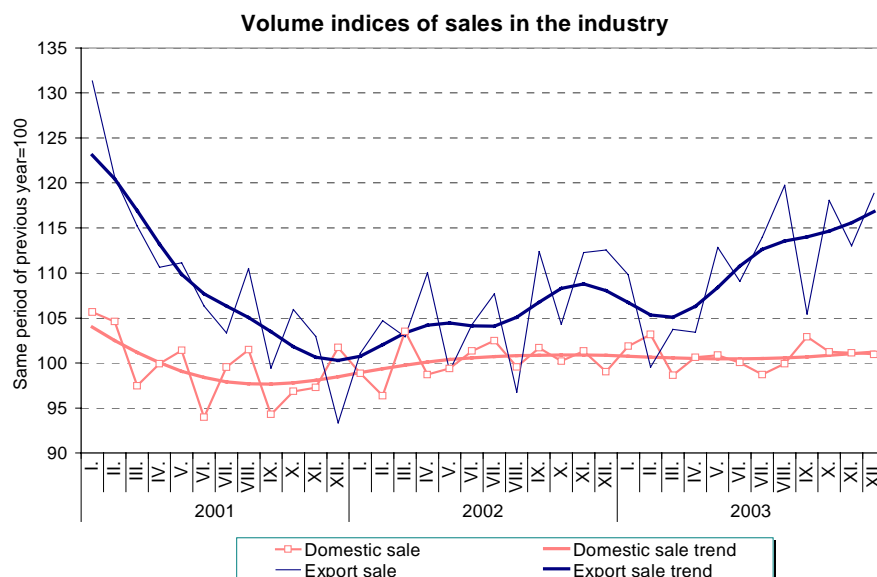
volume index, previous year = 100

	Production	Domestic sales	Export
Q1	104,1	101,8	105,2
Q2	104,2	100,0	107,7
Q3	106,8	100,5	112,3
Q4	109,9	102,0	117,6
2003 year	106,4	101,1	110,9

The driving force of industrial output increase was still the increase in external demand

In sectors producing consumer durables output increased almost exclusively for export purposes (56 %), while their domestic sales dropped by 7 %. The production of capital goods industries increased by 10 %, but their exports increased more. On the other hand, their domestic sales went up by 5 %. The most typical products of domestic sales increase relate to the successful promotion of the Sulinet scheme (computers for students and teachers). Increased demand for certain metallurgy products was determined by the demand of gradually increasing vehicle production and domestic motor vehicle sales went up by more than 6 %, too. Most probably, the expectations related to changes in the housing loan system also contributed to a higher demand for building materials.

No major increase in the demand for the products of the manufacturing in Hungary



Production of industrial enterprises employing more than 5 employees increased by 6.6 % between January and December last year, and that of the manufacturing increased by 7 %. Within that December increase was more than twice the annual average. The most dynamic output increase still related to two major branches of industry: electrical and optical equipment production, as well as transport equipment production. Metallurgy output also increased by more than 10 %, which was partly induced by the dynamism of transport equipment production. The production of the food industry, representing one-sixth of the manufacturing was 0.5 percentage point lower in 2003 than in the previous year, while its export sales went up by 6.4 %. The output of leather and leather product industry, which still showed signs of a crisis, and represented only 3 % together, dropped by 23 %, and the output of the textile industry fell by 7 % compared to 2002.

The two major branches of the manufacturing showed the most dynamic increase

Producer prices of the manufacturing increased by 1.6 % in 2003. Last year's producer price increase was primarily the result of domestic prices, because export sales prices increased only by 0.3 % following a 4.5 % decline in 2002. It was also the result of a weaker dollar and a decline in the HUF value of exports invoiced in USD. The export sales price index was 2.6 % lower than in 2002 in the electrical and optical equipment industry, which produces most tradable goods.

Export sales prices were slightly higher than the rather depressed prices of the previous year

Between January and December, the per capita industrial output went up by 8.8 %, with a 2 % employment decrease. Productivity increased fastest in the electrical and optical equipment industry.

Industrial productivity increase was close to 9 %

The practices applied by large, multinational companies indicated more and more that Hungary has becoming an important logistics base of the Central and Eastern Europe region, also several research development centres have been established here. The majority of such development relates to the utilisation of various products, and manufacture of

Establishment of an increasing number of logistics bases

transport equipment that involves the installation of various products. There are several signs indicating that in case of building materials significant foreign companies build long-term base plants, taking into account the favourable raw material supply in the country. These base plants are also related to the objectives of these companies to acquire markets in the neighbouring (primarily Eastern) countries. Another positive development is that despite the spectacular withdrawal of certain activities of several international companies, the same companies increased their other activities significantly in Hungary (IBM, Flextronics). In general, it is also typical that large multinational companies, operating in Hungary for many years, have launched further major capital investments increasing production capacities, involving also a profile extension (Suzuki, Elektrolux, Bosch, etc.). The settlement of smaller and medium-size enterprises, operating as suppliers to large companies, is another phenomenon observed in Hungary.

The increase of the total orders in 2003 was balanced concerning both domestic and foreign demand. The December volume indices of new orders increased significantly primarily with regard to export orders. The fastest export order increase occurred in paper industry, metallurgy, electrical and optical equipment industry, as well as chemical industry, while most of the domestic orders involved products of electrical and optical equipment industry and the transport equipment industry.

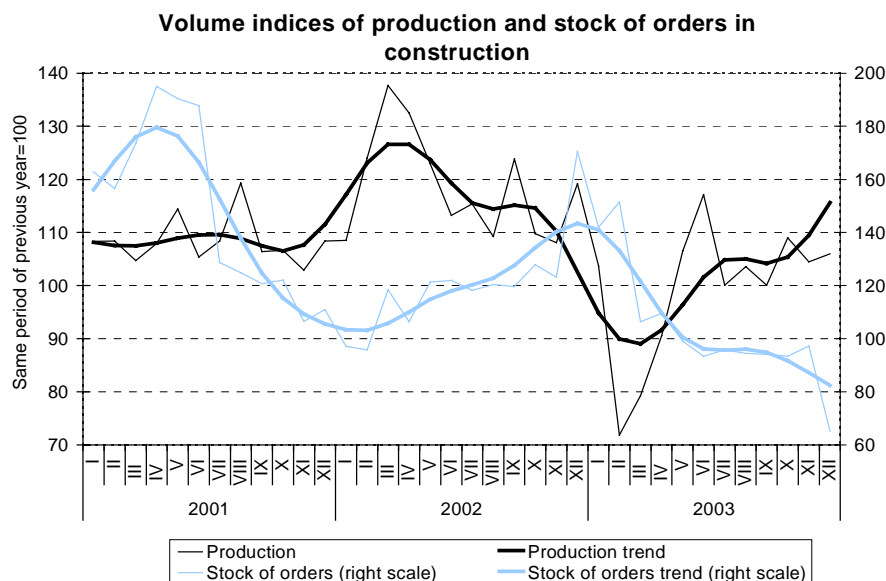
Promising new export orders for industry

The gradually increasing export orders, and dynamisation of capital investments in the manufacturing may represent a basis for acceleration of industrial output in 2004. However, the actual development requires the start of a boom in the international markets, including primarily the markets of West European countries, as it is an indispensable condition. Further encouragement is required for foreign direct investments. The education and retraining policy must be adjusted to actual requirements, in order to increase employment. In a favourable case, industrial output may increase by even 8–10 % this year.

Outlook for 2004

The **construction** caught up on its lag of previous year month-by-month, and after the outstanding growth of 2002 (17.8 %) increased by 0.7 % by the end of last year. The performance of building completion, representing one-tenth of the sector, grew most dynamically, by almost 17 %. The performance of building installation, representing 25 % of the sector, also increased significantly, by nearly 14 %. Performance declined in a sub sector, dominating the whole construction, representing 60 % (building of complete constructions or parts thereof): between January and December performance dropped by 9 % compared to the previous year.

Construction output reached its high 2002 year level



Unfavourable changes continued in the orders. The monthly average new orders in 2003 represented only 70 % of the orders in 2002 at current prices.

The changes of the orders are not promising

Primarily because of the decline of orders, and limited availability of budgetary funds this year, concerning the performance of the construction in 2004, it can be predicted that the growth will lag behind the growth of the national economy, and in a favourable case, it may reach 3 %.

There are many uncertainties in the assessment of construction outlook for this year

Because of the rather unfavourable weather last year, as well as depressed market conditions, **agricultural production** did not even reach the otherwise low performance of the previous year either. The yield of cereal products was only three-fourths of the previous year, and with the exception of sunflowers, there was a severe decline in industrial plants, too. According to the last survey conducted in August, there was a further decline in cattle and pig stock, but there was an increase in the poultry and sheep stocks. As a result of these changes, the production value of animal husbandry in 2003 was higher than in 2002.

Agricultural production has declined further

The purchase of agricultural products was only 0.4 % higher last year than in the previous year, within which the sale of animal products increased slightly higher (5.5 %) than the decline in the sale of vegetable products (5 %). In accordance with the demand and supply rules, the prices of agricultural products were contrary to volume: the producer price index of vegetable products increased by 13.4 %, and it declined for animal products by 5.5 %. These in total resulted in 5.3 % increase in the sectoral producer price index.

Purchasing of agricultural products stagnated, producer prices increased

In 2003, the **transport** carried 1.5 % more goods than in the previous year. Within overall transported goods, domestic transportation stagnated, and international transport increased by 6.5 %. The volume

The performance of the transport improved slightly

of goods transported by railway has been declining for years, last year it represented 25 % of the total transported goods. On the other hand, road transportation has increased continuously, and was close to 62 % in 2003. Concerning passenger transport the number of interurban passengers dropped by 2 %, and passengers transported by local transport declined by 0.4 %.

3. Monetary processes

3.1 Central bank measures

In the middle of January, the central bank purchased foreign currency at the strong end of the band, as a result of the intensive capital influx, which tried to move the exchange rate band up, yet it reduced the base rate to 6.5 %, in total by 200 basis points, in two steps. The interest spread was widened to +/- 3 % in order to hold back the capital influx, unlimited placement of two-week deposits was suspended, and a fixed rate deposit tendering was introduced instead temporarily, the amount of which was limited at HUF 100 billion. As a result of the measures, instead of the 6.5 % two-week deposit interest rate temporarily the 3.5 % overnight deposit interest became the de facto base rate. The central bank held foreign exchange auctions at the end of January in order to reduce the foreign exchange reserves, which had swollen because of the speculative capital influx. The temporary measures were withdrawn after the speculation wave was broken. NBH sold more than 70 % of EUR 5.3 billion, purchased by constraint in the middle of January at first in open, and later in quite intervention by the end of May. With this measure, the majority of speculative foreign investments left the Hungarian banking system without posing a risk for the HUF exchange rate for the stability of the financial sector. Part of the outflow of speculative investments, involving approximately EUR 1.2 billion, took place in a way that the HUF sold by the speculators was not purchased by NBH, but by other market participants hedging their exchange rate risks. On 26 May, the central bank announced that it would stop intervention within the band and return to its former policy according to which it would try end influence the exchange rate within the exchange rate band with its interest policy.

NBH monetary policy measures put an end to speculations aiming at the modification of the band

In order to put the brake on the devaluation following the shift of the exchange rate band in June, in June the NBH increased its base interest paid on two-week central bank deposits from 6.50 % to 9.50 % in two steps. The yield increase resulting from the second, 2 % interest increase stabilised the HUF exchange rate in the range of HUF 250-260, considered necessary by NBH in order to satisfy the Maastricht criteria. In its announcement issued with the inflation report, the Monetary Council declared that a interest rates could only be decreased, if the exchange rate stabilised in the upper part of the 250-260 HUF/EUR band. Although at the beginning of October, the HUF exchange rate reached the upper part of 250-260 HUF/EUR band, the interest rates were not reduced. In the middle of the month, the HUF exchange rate

Temporary stabilisation of the exchange rate after the movement of the exchange rate band

started to weaken, and at the beginning of November, the signs of yield speculation appeared in the secondary market of government securities. In order to put a stop a yield increase following this phenomenon, NBH first applied verbal intervention, and then, in order to consolidate the government securities market, it purchased government securities in the market

In relation to the weakening exchange rate at the end of November, NBH confirmed that on the basis of the economic processes, it could not accept the weakening of HUF, and then it increased the indicative interest rate by 3 % following verbal intervention with very little effect.

NBH reacted to the new speculation wage against the HUF with a 3 % interest

The Monetary Council does not intend to offset the impact of indirect tax increases introduced in 2004 with stricter monetary conditions, it only intends to act against the durable inflation effects of the price index increase, which are reflected in the impacts on inflation expectations. In its announcement, issued on 19 January, the Council stated the following: "Irrespective of the scheduled date of EUR introduction in Hungary, the primary objective and legislative obligation of NBH is to create and maintain price stability. It is also in line with the legislation and expectations of the European Union. In this spirit, the Monetary Council will focus its decisions to achieve the 4 % inflation objective, set by the end of 2005." According to a declaration made by the president of the central bank at the end of February: "As long as they see that there are tensions in the economy, which lead to an inflation higher than the set 4 % inflation target, the interest rates must remain as high as they are."

The **mandatory central bank reserve** regulations were amended on 1 January 2004. According to the changes, deposits and loans with more than two years' maturity are fully exempt from reserves, and so the range of liabilities subject to reserves was reduced. These measures were introduced in relation to harmonised with the instruments of the European Central Bank and the principles of competition neutrality. From 1 January, the calculation method of the reserve base has changed, too: instead of the monthly average liabilities, subject to the reserve obligation, credit institutions should use the data of the last day of the month for the calculation of their reserve obligations. In addition, the gap between reserve calculation and generation periods increased from 1 month to 2 months, which is also in line with the ECB practice.

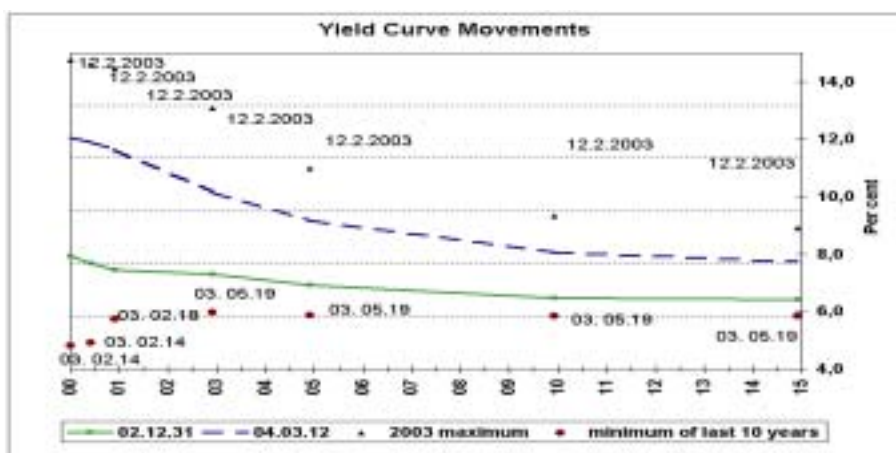
NBH harmonised mandatory reserve regulations more to ECB practices

On the basis of the decision of the Monetary Council, from July 2004 the NBH shall stop issuing monthly reports, which is in accordance with the requirements and practice of the European Union. It will only publish a detailed **balance of payments statistics** quarterly. From September 2004, whenever quarterly data are published the data of the previous two quarters shall also be revised.

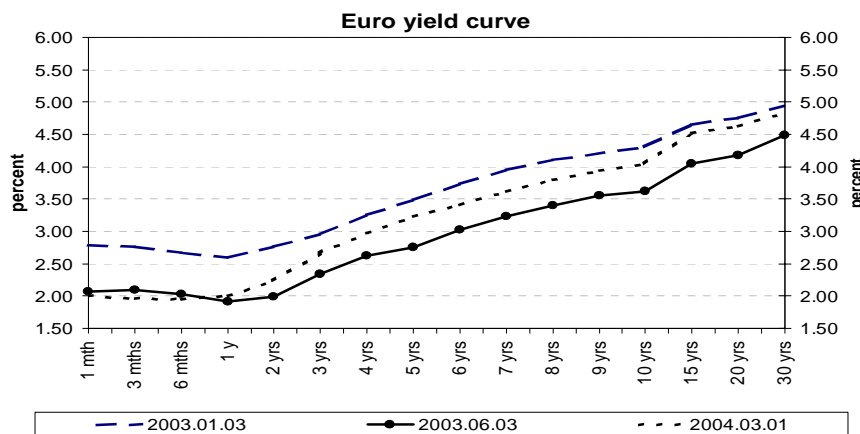
3.2 Yield and interest rates

2003 can be described with extremely large volatility and significantly increasing yield levels. While at the beginning of the year, the yield curve remained horizontal around 6 %, in the second half of the year, the curve became inverse again, and it increased in all sections. The short side moved in accordance with the five interest rate decisions made by the central bank, involving at least 100 basis points on each occasion. The long-term yields increased as a result of the assumed or actual deterioration of the financial balance, and market problems occurring as a result of the loss of credibility of the economic policy. There was much less volatility than before in the first two months of 2004, for a long time short-term yields corresponded to 12.5 % of the base rate, then at the beginning of March they decreased by 50-100 basis points.

Strong yield increase in 2003

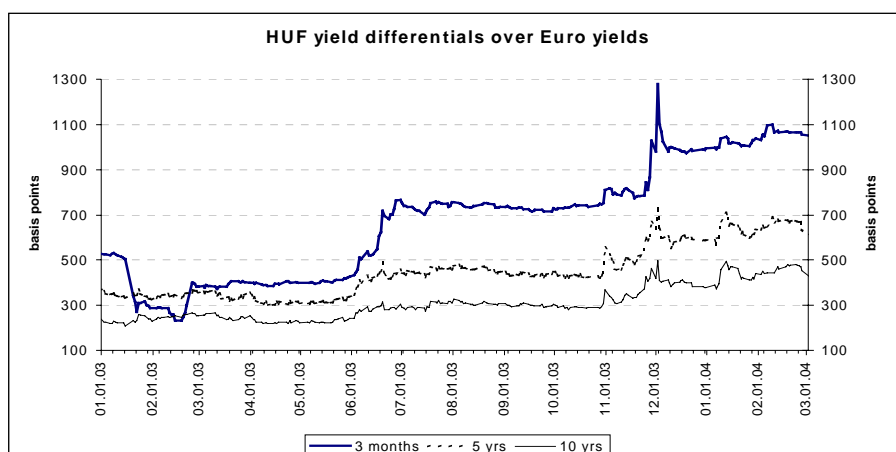


The convergence of HUF yields to EUR yields came to a halt in 2003. The EUR yields in 2003 can be broken into several phases. The former yield decrease continued until June, and it was followed by an increasing tendency until November. Ever since the yields of the euro zone have been stable. In the meantime, with two interest rate reductions involving 75 basis points in total, ECB reduced its base rate to 2 %, which is the lowest figure ever, as a result of which the short-term yields have remained around this figure since the middle of last year.

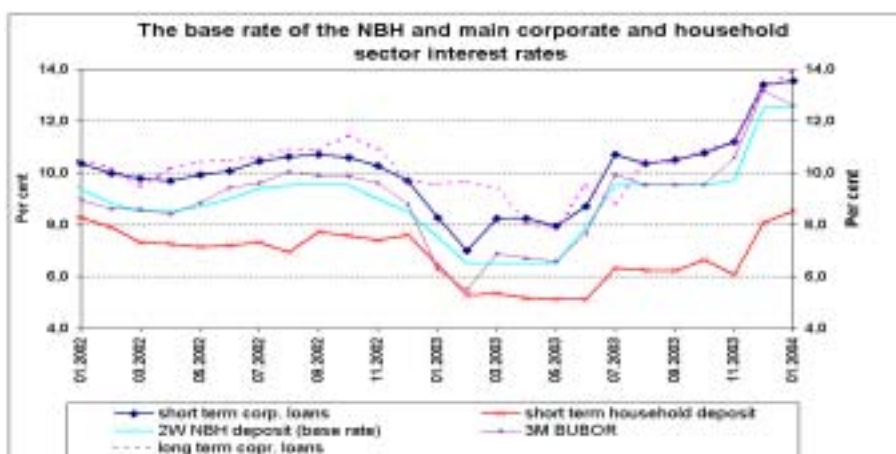


Similarly to HUF yields, the Hungarian premium over the EUR was also volatile in 2003. While at the beginning of the year, it dropped to 300 basis points in the 3-month segment, in December it was higher than 1,000 basis points and it was at the same level at the beginning of March 2004, too. The decline in EUR yield was also involved in this trend, although to a small extent only. There was also a large increase in long-term yields, but of course measuring in basis points the change was smaller than that of short-term yields.

Significant increase in the Hungarian interest premium over EUR



Apart from the special period at the beginning of 2003, both deposit and loan interest rate trends moved alongside the central bank interest rate, while the 3-month inter-bank interest rate also reflected the base rate. While changes in the loan interest rates were closely related to the base rate, the deposit interest rates followed the June interest increases only partly, but the November increase was also reflected in this segment almost completely.



The ex ante and simultaneous real interest rate indices increased to an extraordinary high level by the beginning of 2004. This was due to a strong yield increase and lower, but also significant inflation and inflationary expectation increase. In the meantime, the ex post index kept falling and became negative in March 2004, because it reflects the low yield at the beginning of 2003 and current higher inflation. However, when the already increased yield level and the lower inflation, expected

Real interest rates increased in 2003

in the second half of 2004 are reflected in the calculations, a significant increase can be expected in this index, too.



The ex-post real interest rate ratio: yield of one year discount treasury bill issued 12 months ago, deflated by the current inflation. Ex ante: current one year discount treasury bill yield deflated by the inflation rate expected by analysts to develop in a year's horizon. Simultaneous: current yield to current inflation rate.

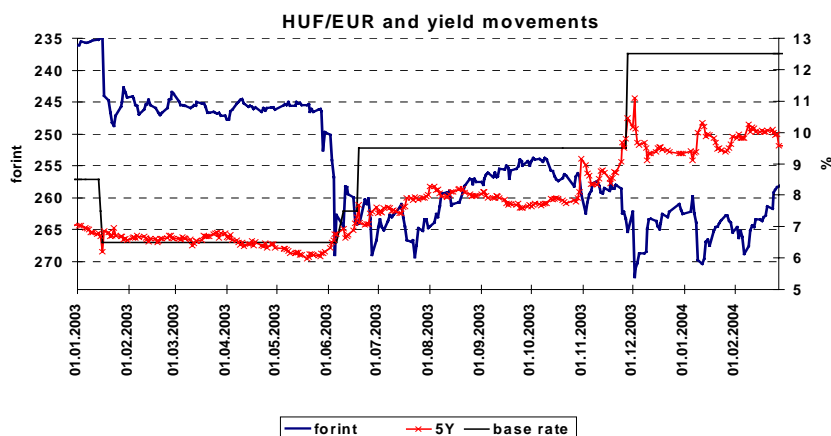
3.3 Exchange rate

There are three different problems behind the three strong exchange rate changes taking place in 2003. These are the following: the attitude of NBH, according to which the exchange rate has a determining role in achieving the inflation target; inconsistency between the inflation target, fiscal policy and incomes policy, communication errors, which reduced to minimum the credibility of the exchange rate and monetary systems.

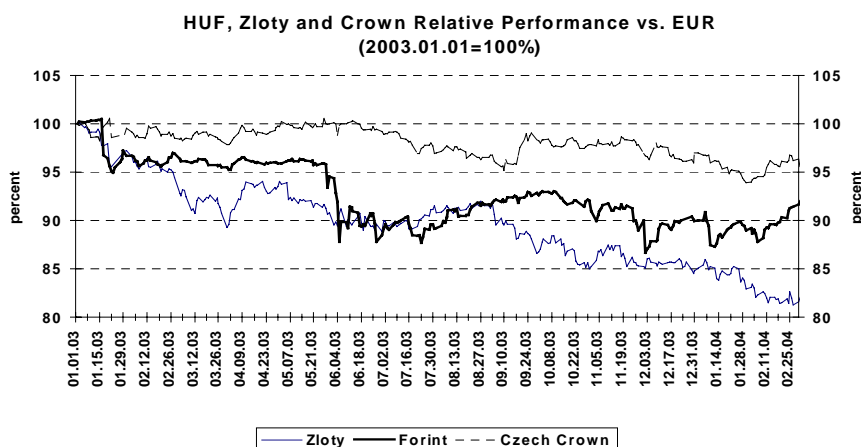
The improvement of economic fundamentals, and coordinated central bank and government measures are gradually reflected in the strengthening exchange rate, in accordance with the position of the economy, too.

These are also supported with the analysts' expectations surveyed in the Reuters poll on 26 February, according to which by the end of year the exchange rate is expected to be around 260 HUF per euro, as observed during the time of the survey, but by December 2005, the projected exchange rate is approximately HUF 4 stronger.

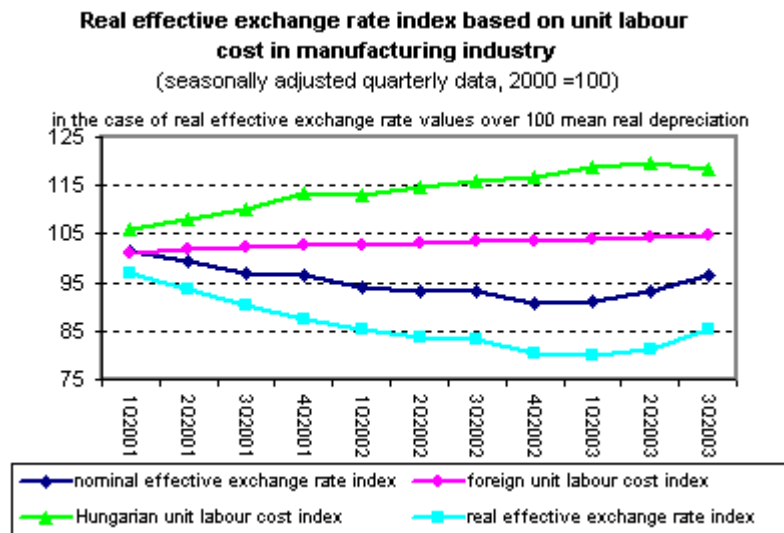
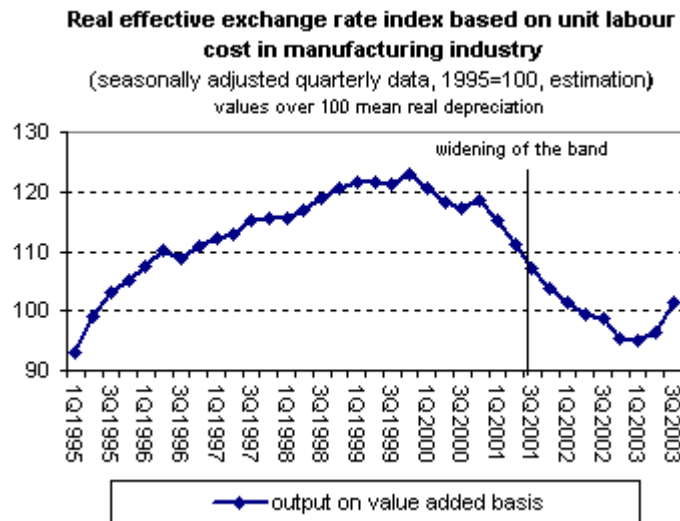
Following the processes taking place in 2003, the exchange rate is gradually strengthening as a result of coordinated central bank and government measures, and improving economic fundamentals, and is in accordance the situation of the economy



Comparing the exchange rates of the Czech crown, HUF and zloty, it can be concluded that the Czech crown is stable, the zloty has weakened significantly, and the HUF performed between the two.



The favourable **competitiveness** of the Hungarian national economy, considered in international comparisons deteriorated in 2001-2002. Compared to our main competitors, the Hungarian position has taken an unfavourable turn. During that period, red appreciation was approximately 16 % on the basis of the consumer and producer price index of domestic sales price index of manufacturing industry, while it was approximately 17 % on the basis of the units labour cost index of the manufacturing industry. Apart from the nominal appreciation of HUF, the most important factor of red appreciation was the significantly faster wage increase than the moderate increase in productivity.



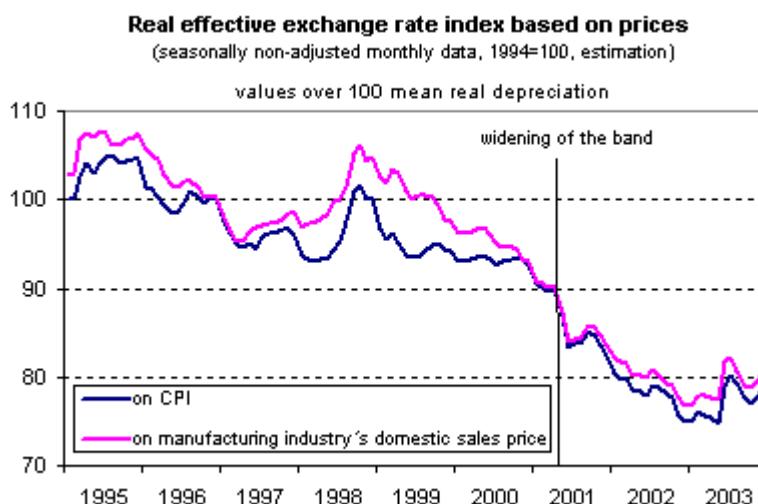
There was a major change in the tendency last year, primarily because of the weaker exchange rate, and also in relation to the slowly starting adjustment. Compared to the significant deterioration of competitiveness measured on price and cost base in 2001-2002, stagnation and potential improvement can be expected.

The real effective exchange rate indices measured on consumer price index and domestic sales price index of the manufacturing industry in 2003 indicated only approximately 1 % real appreciation as an annual average. However, it is also very important that compared to the end of 2002, there was no deterioration even in the first five months of the year; from June there was a significant change in tendency, as a result of a weaker nominal exchange rate, competitiveness started to improve.

There are preliminary data of real effective exchange rate index based on unit labour cost only for the first-third quarters of 2003. The cost-based competitiveness tendency was similar to the price-based one, while the comparison of the average for first-third quarters to the same period of

There is a significant change in tendency in competitiveness; after significant deterioration in the previous two years, in 2003 there was stagnation and improvement started, too

the previous year indicates only a significant deceleration of real appreciation but, comparing the third quarter of 2003, and the last quarter of 2002 a considerable improvement of approximately 6 % can be seen. The available information indicate that the last quarter of last year also involve an improving tendency.



This year, cost competitiveness may improve, in which a major element is that as a result of dynamisation of production, the growth rate of Hungarian unit labour cost can reduce slightly and turn out to be more favourable in comparison with our major trade partners as a result of a better accordance between productivity improvement and wage increase. The change will be unfavourable again in price-based competitiveness due to temporarily increasing inflation this year. However, even if disinflation starts again, we should still expect a moderate price-based real appreciation, because the equilibrium rate of inflation of the Hungarian economy moving along on a catching-up path is higher than the average of our main trade partners. However, even as an average of a longer period, the utilisation of the growth potentials of the economy allows for annual 1-2 % real appreciation on a consumer price index basis at most.

This year, improvement is expected in cost competitiveness, but deterioration is forecast for price competitiveness

3.4 Financial markets

3.4.1 Banks, insurance companies, funds

In 2003, the state subsidised housing loan expansion was a dominant factor for the **banking sector** in several aspects: it had a fundamental effect on the balance sheet structure and profits. As a result of bank privatisation, the proportion of foreign investments (Postabank, Konzumbank) was higher than 97% at the beginning of 2004³. In 2003, the major impacts on the balance sheet structure included a dynamic increase in lending, the speculative attack in January and HUF depreciation. In total, the total assets of the banking sector increased by

Stable financial sector, increasing total assets and increasing lending

³ Compared to the registered capital of the banking sector without MFB and Eximbank.

17 % in the first three quarters of the year.

Lending continued to increase in the first three quarters of the year: the loan portfolio increased by 24 %. Loans to enterprises went up by 17.5 % compared to the end of 2002, while household credits increased by 50 %, although portfolios are still low in international comparison. Owing to a move towards more profitable lending, the ratio of liquid assets of the banks reduced further. The majority of additional funds resulted from an increase in liabilities from foreign securities and mortgage bonds, while there was also a very slight increase in domestic deposits.

There was a slight improvement in the portfolio quality of the banking sector compared to the end of 2002, although it slightly deteriorated in the third quarter. The earnings and profitability of the sector were both favourable in 2003, the profit of banks exceeded HUF 200 billion. The capital adequacy is still stable, and, compared to 2002, there has been an improvement, too.

Insurance companies continued their growth, which was reflected in the increase of premium revenues and reserves, too. At the same time, the composition of the investments of insurance companies did not change significantly. The majority of their portfolio still consisted of state securities in all insurance branches.

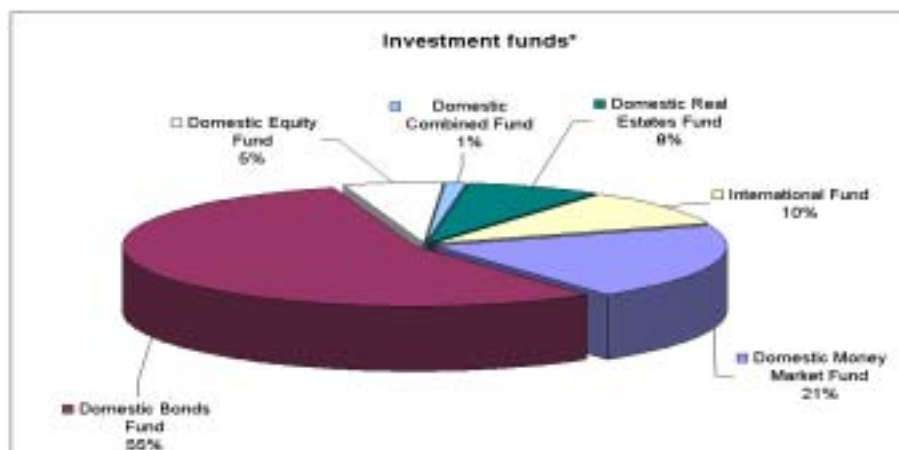
The **fund sector** is still determined by the position of private pension funds and voluntary pension funds. The number of members of both types increased in the first three quarters of 2003, primarily as a result of mandatory private pension fund membership, which was restored as an obligation of young people starting their career. This increase offset the reduction in the number of membership, which took place in 2002. There was a dynamic increase in the amount of contributions paid to private pension funds, which resulted from a one percentage point increase of contribution, the gross nominal wage increase and an increase in the number of members. The assets managed in the funds increased by 30 % in the first three quarters, and 40 % in the whole year. On the other hand, the composition of the portfolio did not change significantly, the investments into government securities still dominate the portfolio.

3.4.2 Investment funds

The investment funds closed a mixed year in 2003. In the first half of the year, there was a dynamic increase in the net asset value of the funds, but in the second half of the year, this process turned around as a result of increasing market yields, which resulted in a decline of government securities and investment unit prices. There was a major increase in the total assets, especially at the end of the year and at the beginning of 2004, and it was primarily observed in bond funds, representing the largest share in the market of funds. On the other hand, real estate funds quadrupled their net asset value in one year, but their market share is still below 10 %. Concerning proportions, in 2003, equity and real estate

*Investment funds
closed a mixed year.*

funds increased their share significantly, while the share of bond funds decreased considerably.



* * Source: Bamosz, 31. January, 2004

4. Inflation

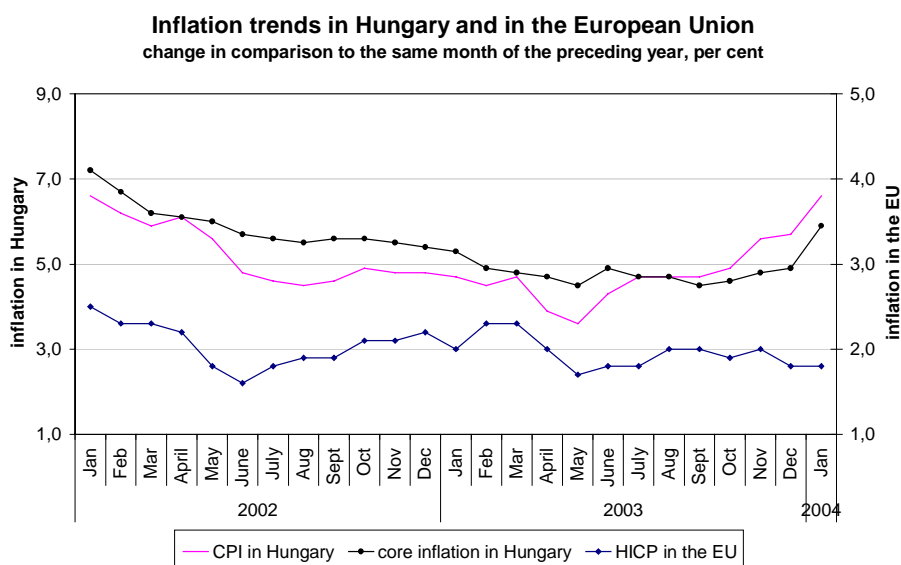
According to CSO data in the first half of 2003 the inflation figures were favourable (in May prices were only 3.6 % higher than in the same month of the previous year). After the turn in the trend, which occurred in June, the rate of inflation stagnated in the third quarter, and the twelve months' index started to increase in October, continued its growth in November, and exceeded the expectations. By December, the twelve months' price increase rate reached 5.7 %.

In 2003, the fast disinflation of the first six months was followed by an increase in the price index

There are partially seasonal reasons behind the fast disinflation of the first half of the year (prices of unprocessed foodstuffs, regulated prices), but the core inflation, reflecting the basic processes also declined. On the other hand, accelerating inflation towards the end of the year was related partly to the turn in these processes (agricultural producer price increase, regulatory price measures), and partly to a faster price increase of industrial articles, which showed strong disinflation earlier, and followed the weaker forint. The demand represented by the purchasing power, which increased in the last few years was mainly reflected in a price increase, which exceeded the average price increase of certain services.

Even with all these changes, inflation declined in 2003, too, compared to the previous year. Its annual average rate was 4.7%, which was the lowest figures for 22 years.

The annual inflation rate decline in 2003, too



Core inflation and CPI difference shows a strong effect on price-forming factors

2004 requires separate consideration for several aspects. The market-driven price increase rate reduced to a moderate level for the last few years. Parallel with a deceleration in consumption and stronger market competition, this trend is expected to continue and get stronger in 2004. The increase of the preferential VAT rate, and the excise duty increase drove the prices up, but they were accompanied with other regulatory price measures, managing old tensions, too (certain measures were introduced in the second half of 2003, but others are only effective from this year).

The basic economic processes indicate disinflation

According to CSO estimates, nearly half of the 2.1 % price increase in January and more than one-third of the 1.2 % increase in February were caused by changes in VAT and excise duty. This means that the other part of the price increase corresponded to the January and February rates of 2003. In the case of tobacco products, the changes of the excise duty will be reflected in the price index in the next few months.

A significant part of consumer price increase is the result of one-off items

In the second half of 2003, as a result of the statistical impact of accelerating inflation, and one-off price increasing steps taken at the beginning of the year, the index measures on the basis of the same month of the previous year will increase to 7-7.5 % during the months of the second quarter, followed by a major reduction by the end of the year. The disinflationary European environment, balanced world market price developments parallel with a weak dollar represent favourable conditions. On the other hand, with a significant change in the structure of macro-economic processes, and significant decrease in the growth rate of consumption, the projection contains more uncertainty than usually. The annual price increase rate in December is predicted around 5.5-6 %, and the annual average inflation is predicted around 6.5 %.

Temporary increase in the consumer price index in 2004

Looking at the COICOP group of the consumption basket, the following main conclusions can be drawn: although the agricultural prices (producer prices of crop products) started to increase since June 2003, which was

The prices of foodstuffs are driven by the cyclical changes of

reflected in higher inflation of food and non-alcoholic beverages, but as a result of the first half of the year, the average price of these products was only 1.5 % higher in 2003 than in the previous year. The fast price increase can continue in the first half of 2004, too, then deceleration is expected from July. The increase of the preferential VAT rate is another significant price increasing factor. Thus the average price increase in 2004 could exceed the average. In the category of alcoholic beverages and tobacco products, the most important factors included an increase of producer costs and changes in excise duties. On average, there was a 10.7 % increase in this category in 2003, which can be slightly higher in 2004 as a result of the major increase in excise duty.

agricultural producer prices

Clothing and footwear are typically seasonal products. With significant monthly price fluctuation in 2003 the twelve months' rates were typically around 3 %, similarly to the annual average, too. In 2004, a similar price increase can be expected.

Disinflation is the strongest among industrial articles. In the case of consumption items statistics registered a nominal price increase on several occasions. The price increase of motor vehicles is primarily related to the weaker HUF, which process started in June. The market competition is most striking in this category, thus similar processes can be expected in 2004, too, and they are confirmed by the statistical data of the first two months as well.

Low inflation among industrial articles

The category of housing services showed a price increase above the average rate of inflation in 2003. The impact of the price increase related to natural gas was reflected in the July price index, and that of electricity occurred in the September price index. The repair and maintenance services, priced at the market, as well as communal services (primarily refuse collection and sewerage services) also went up above the average. After the 6.6 % price increase throughout the whole 2003, the prices will go up faster in 2004, primarily as a result of an increase of the preferential VAT rate, a change of the VAT rate applied to electricity and the implemented environmental loading fee. In the first two months of the year, 6.4 % price increase occurred in the category compared to December 2003. The average price increases of certain services, lower price increase, and sometimes decrease related to consumer durables, general industrial articles and general supplies formed the low, 0.8 % annual index in the category of furnishings and household equipment, which can be followed by a similar increase in 2004.

There is a higher price increase in housing services than in product prices

It is still true that the price of market services goes up above the average. It can be observed primarily in areas where the services do not have a substitute or a competitor because of their nature and/or in the local market, or whenever the increasing purchasing power allows for a higher price increases. The difference between the price increase between services and industrial articles can be considered stable.

Service prices go up above average

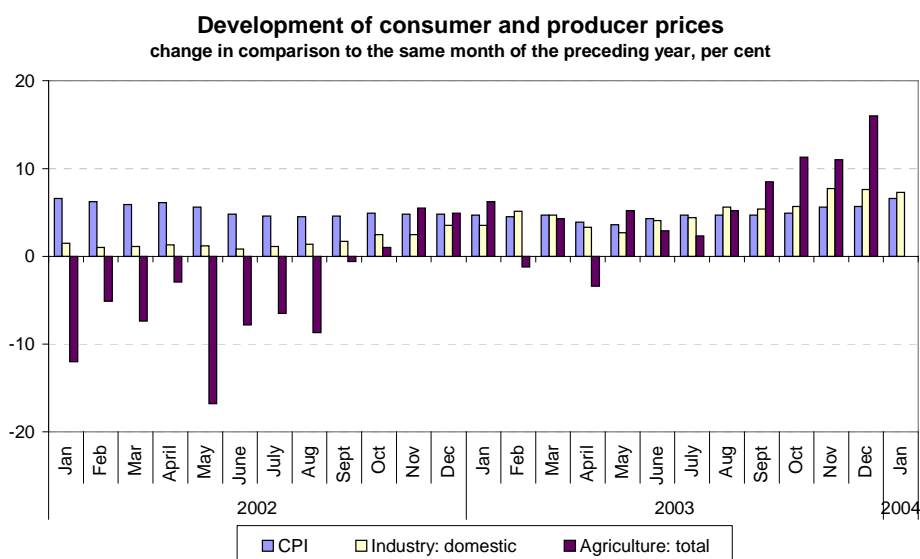
In health care, the importance of pharmaceutical products is fundamental. The prices of pharmaceutical products went up by 7.2 % on average in 2003, and by 16.1 % in January 2004. Because of the nature of drug consumption, it cannot be assumed that the limit of demand hinders the integration of the impact of VAT introduction into prices.

In the transport category, the price of motor vehicles and parts (occasionally falling prices in the first half of the year, followed by sudden changes in August, for example, in the price of new cars), fast increase of prices of operation and maintenance services, changes in local and long-distance transportation charges, and rather volatile changes in fuels could be observed. The average annual price increase was 4.4 % in 2003, and the same average figure is expected for 2004, too.

Following a moderate annual 1.2 % price increase for telephone services, in telecommunications price stability, or perhaps a nominal price decrease can be expected in 2004 as a result of strong competition. Regarding recreation and culture, the prices of repair services increased, but the prices of equipment and instruments available for purchase decreased. On the other hand, book, periodical and newspaper prices went up significantly. The prices of leisure and cultural services also went up. The average annual 3.7 % price increase was below the average and the figure could be similar in 2004, too. The higher than average, more than 10 % price increase observed in education, can be considered a durable trend, prevailing in 2004, too. The price increases in category of restaurants and hotels were above the average in 2003. Similarly to the majority of market services, the future prices will be determined by payroll expenses and purchasing power, which will most probably involve a slow price increase. Among miscellaneous goods and services, apart from hairdressers' and body care services, the outstanding price increases related to insurance and financial services should be mentioned. In the latter group, similar price increases could be observed in 2004, too.

Significant increase in the price of books and newspapers, and market services went up over the average, too

There were significant difference in the prices of the production sector.



Typical fluctuation in agricultural producer prices

As an average of the first six months of 2003, agricultural producer prices were 0.4 % below the same period of the previous year and then, as a result of a fast price increase, they were 5.3 % higher throughout the whole year than in the previous year. In the case of crop products, the average price increase was 13.4 %. There was a significant price increase for wheat, corn, potato, wine and grape juice. Regarding animals and animal products, more balanced prices could be observed, and the average price level was 6 % lower than in the previous year. The price index of crop products could remain high in the first half of 2004, followed by a reduction, which may bring a balanced price structure in the second half of the year. Agricultural prices are difficult to predict, but in the case of shock free pricing they do not represent an inflationary factor.

Producer prices started to increase fast in the plant production in the second half of 2003; the situation can be consolidated by the middle of 2004

As an average of the first half of the year, domestic industrial producer prices were 3.9 %, and as an average of the year 5 % higher in 2003 than in the similar period of the previous year. The increase was considerable mainly in the energy producing sectors, but the twelve months' index started to fall in December. In the sectors producing consumer durables, the index increase in the second half of 2003 can be explained with statistical reasons. The price increase of sectors producing intermediates accelerated, and prices of sectors producing non-durable consumer articles also went up. In the case of this latter one, the relationship with agricultural producer prices was also important. Concerning sectors producing investment goods, the price increases accelerated mainly for reasons for an economic recovery. Taking into account projections for international price trends and Hungarian economic recovery the average price increase projected for this year is similar to 2003. Exports sales prices in HUF have increased since the middle of 2003, and in total they were 0.3 % higher than in 2002.

Domestic industrial producer prices increase fast in 2003, primarily in accordance with energy prices, but in 2004 balanced prices are expected

In the construction industry, the cost-based producer price index was 105.7 % in 2003, which falls a considerable growth compared to the

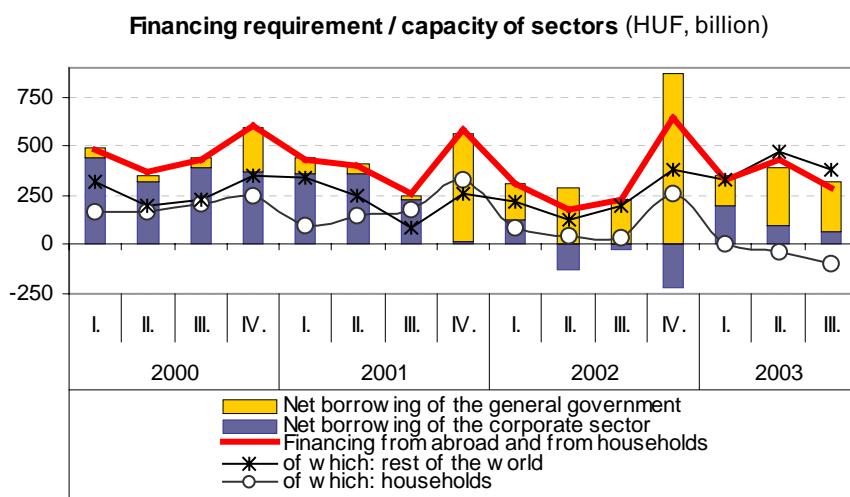
previous year. Until May, the index was around 105 %, and from June it was above 106 %. The boom and cost changes are both reflected in the prices of the construction industry.

5. Income, financial processes, equilibrium

5.1 Equilibrium factors

The latest complete information about the equilibrium indicators of the national economy, financing requirements/capacities of economic sectors is only shown in the financial accounts of the third quarter of 2003. The external financing further increased in the third quarter of last year, too, and compared to the same period of 2002 the financing requirement of the national economy more than doubled and amounted to HUF 1,183 billion in the first three quarters. There was an unusual situation in two subsequent quarters in which the financing demand of the economy was covered only from abroad with the lack of domestic savings. Households remained net borrowers in the third quarter, too (HUF -96 billion, first-third quarters HUF -130 billion), primarily as a result of the dynamically increasing housing loans. On the basis of data available since 1998, the households' net financing position has never been negative. Corporates remained in a net borrower position (in the first-third quarters financial and non-financial companies together: HUF -355 billion). General government financing requirement remained considerable (first-third quarters: HUF -708 billion).

In the first three quarters of 2003, the financing requirement of the economy was covered from abroad



On the basis of the available partial information, it can be assumed that the unfavourable trends took a turn in the fourth quarter of the year. The net financial position of households improved, thus the households turned to be slightly net savers. The increase of the current account deficit and therefore external financing decelerated in the last quarter. Despite this in the entire year of 2003 the external financing requirement of the national

In the fourth quarter, the former unfavourable trends turned around

economy⁴ reached approximately 8 % of GDP, which involved more than 2 percentage points deterioration compared to the previous year. This is explained by low household savings, and an increase of corporate borrowing in relation to their increased investments, as well as the fact that although compared to 2002, there was a significant decline in the government financing requirement, it was still very high.

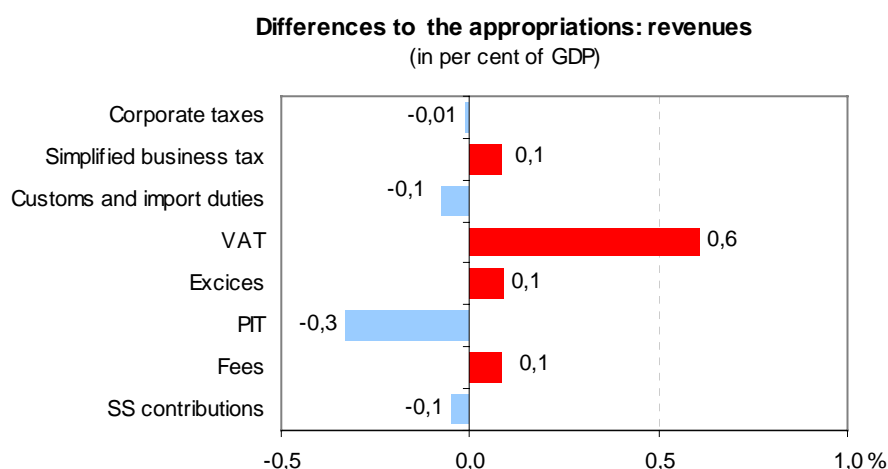
According to our expectations in 2004, the external financing need of the economy will slightly reduce. We expect households to be in a moderately net savings position, too. Compared to 2003, the government deficit will be reduced by at least 1 percentage point, which will allow the corporate sector to increase its borrowing, while the external balance to improve.

External financing can be reduced in 2004

5.2 General government

According to preliminary cash-flow data in 2003, the central government deficit was HUF 1,054 billion (contrary to planned HUF 832 billion). The deficit of local governments exceeded the appropriation only very slightly. Compared to the budget appropriation for 2003, the extra deficit of the central government was caused primarily by the increase in expenditure. In total, revenues exceeded the budgeted figure, although in the case of certain items, they were behind the projections, which were adjusted upwards during the year.

In 2003, the cash-based deficit of the central government was HUF 1054 billion



Within revenues, the main items turned out differently. While wages and salaries increased by 13 %, only slightly more than 3 % increase could be observed in personal income tax revenues compared to the previous year's amount. In addition to the amount allocated to local governments, the revenues of the central budget were below the 2002 amount or the appropriation. The shortage, representing 0.3 % of GDP was related to changes in the tax regulations, and extension of exemptions, which had a revenue effect contrary to the projections. There was a slight shortage of

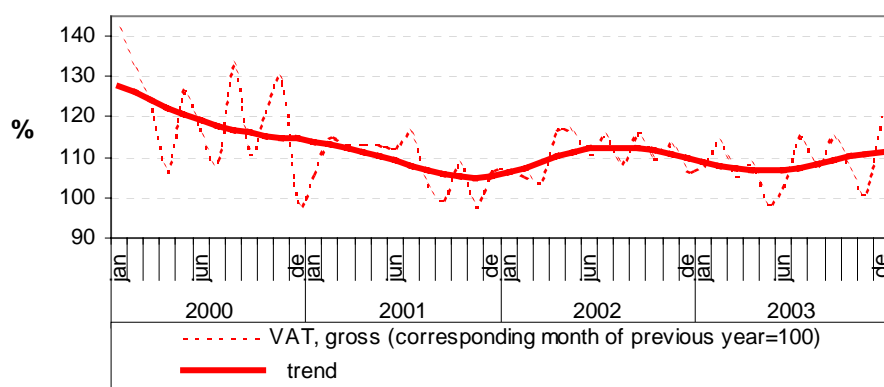
Various items turned out differently, but in total revenues were not short

⁴ The indicator represents the balance of the current account (including re-invested earnings) and balance of the capital account.

social security contribution revenues and the customs and corporate tax revenues of the central budget, too. Compared to the original appropriation in this latter category, the shortage was very little (although it was more significant compared to the appropriation increased in the framework of the Act on the Final Accounts of the 2002 Budget).

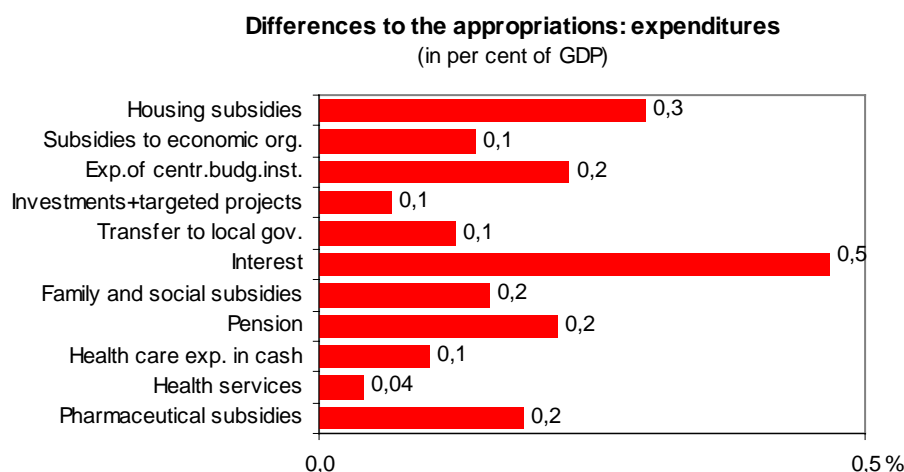
However, the shortages were offset with the simplified business tax, which turned out to be more successful than expected, the consumption tax and excise duty, and mainly the extra VAT revenues. The budget collected more VAT revenues than the original appropriation, or the appropriation increased in the framework of the Act on the Final Accounts of the 2002 Budget (although the extra amount did not reach the December forecast). The favourable change in VAT revenues was also the result of changes in the refund procedures introduced in 2003. The gross VAT revenues increased by 8.5 % in the whole year, and the monthly increase rates accelerated in the second half of the year.

Development of gross VAT revenues



The 2003 deficit exceeded the forecast primarily because of the higher expenses than budgeted. The interest expenses on the debt service exceeded the appropriations by the largest amount, in the case of which the extra expenditure amounted to 0.5 % of GDP. These involved higher issues, required because of the larger interim deficit, exchange rate impacts, and higher yields than planned. The deterioration of primary deficit compared to the appropriation (approximately 0.9 percentage point of GDP) was lower than that of the total deficit at the level of both the general and central government.

Higher than planned deficit was caused mainly by increased interest expenditures...



The second largest extra expenditure, representing 0.3 % of the GDP occurred in relation to housing subsidies. This was partly related to the unexpected use of loans, and the increase of interest rates. The housing subsidy system had to be restricted last June and December in order to ease the burden on the budget. (However, the impacts of these modifications will occur only later, and the increase of expenditure could not be avoided as the loan portfolio increased much faster than forecast.) The unpredicted expenditure items also increased budgetary outlays, e.g. the extra expenditure in family and social support related to the payment for mothers on maternity leave. The extra expenditures of central budgetary institutions was of a different nature, in which case the increment was covered mainly with amounts allocated from reserves.

...and housing subsidy

The supplementary pension increase in November, payment of pension for the 53rd week, and increase of widow pension represented an extra pension expense for the social security system, amounting to 0.2 % of the GDP. The additional medical drug subsidies represented a similar figure (although they occurred regularly in the former years, too). These subsidies even exceeded the appropriation increased in the framework of the Act on the Final Accounts of the 2002 Budget.

Together with slight excess amounts, all these caused an approximately 1.3 percentage points higher GFS deficit than projected, and the deficit of the government sector according to ESA95 is estimated as a similar figures.

The Act on 2004 Budget determined the general government deficit at 3.8 % of GDP according to ESA95, and its primary deficit as 0.3 % of GDP. This year there will be a temporary increase in the gap between accrual and cash-based indicators. With the accession in May, the VAT settlements related to EU imports will be similar to that on domestic trade, therefore, the VAT payment based on one-month import will occur only later in cash. The two types of accounting will be affected differently by the legislative change related to the wages for the 13th month. As a result of all this, the 3.8 % ESA deficit corresponds to a GFS deficit

The projected deficit for 2004 was 3.8 % of GDP

representing 4.6 % of the GDP.

On the basis of the accrual-based data, and in comparison with the 2003 appropriation, the act contained a slightly less than 1 percentage point increase in redistribution ratio with a more than 1 percentage point increase in the centralisation rate. (Apart from the EU-related items, increasing both the revenue and expenditure side of the budget, the changes in appropriations involved a slightly falling expenditure/GDP ratio, and more than 0.5 percentage point increase in the revenue/GDP ratio.)

The internal proportions of expenditure moved towards capital type expenses (capital expenditure and capital transfers): within the appropriations the share of current expenditures declined by more than one percentage point and that of capital expenditures increased by a similar extent.

Declining current and increasing capital expenditure

The Government reviewed the 2004 appropriations at the beginning of the year based on the processes prevailing in 2003. These indicate that this year, the budget revenues may be lower, and expenditure could be higher than planned, consequently the deficit can also exceed the appropriation. Despite the fact that the 2003 cash appropriations were finally met, the amount of tax revenues lagged behind the projections representing the basis of this year's revenues. The heavy increase of housing loans continued in the second half of 2003, and even in December, and the end-of-year financial market development, and the increased interest rates may also cause significant additional expenses.

As a result of last year's processes...

In view of the developing processes, the Government decided to block HUF 185 billion from the expense appropriations in January (including also the HUF 35 billion blockage, decided last December). Approximately 45 % of these measures affect current expenses, and 55 % relate to capital type expenditure and subsidies. Taking into account these measures, too, the expected deficit according to ESA has been changed to 4.6 % of GDP. This involves a deficit representing 5.8 % of GDP on cash basis, amounting to HUF 1,180 billion at central government level.

... following the savings measures, the deficit could amount to 4.6 % of GDP

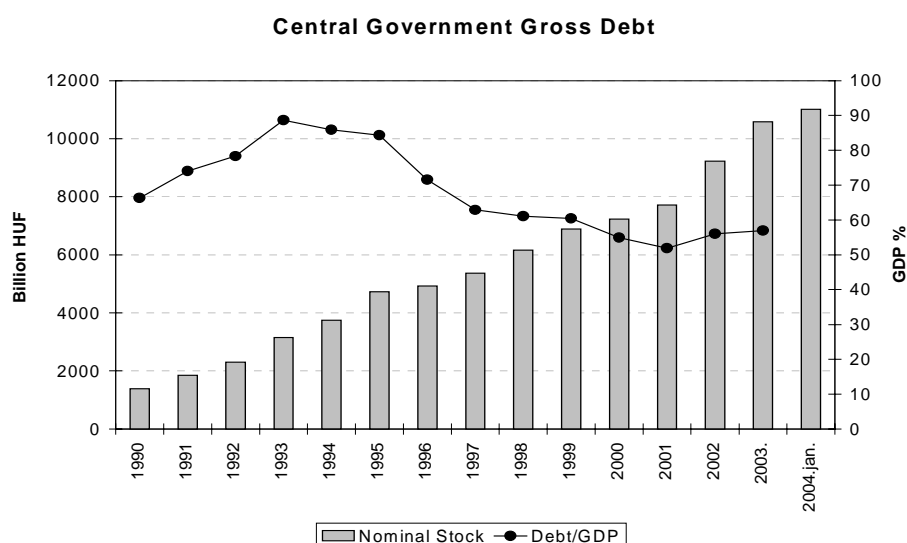
During the first two months of the year, of the total HUF 1,180 billion deficit HUF 341 billion (nearly 29 %) occurred. Apart from seasonal effects, this also involved one-off payments – included in the approved budget – made in January in relation to motorway construction, payment for Grippen planes and agricultural subsidies. In February, the deadline for the payment of the excise duty fell on a weekend, therefore approximately HUF 42 billion excise duty was paid in March. However, both in January and February, the deficit was more favourable than it had been expected.

Key figures of the **public debt** on 31 December 2003:

- Central government gross debt: HUF 10,588 billion (56.7 % of GDP on cash basis⁵)
- Average term to maturity: 3.44 years (HUF), 4.8 years (foreign currency)
- Duration: 2.1 years (HUF), 3.4 years (foreign currency)
- Composition of the public debt:
2003: 76% HUF, 24% currency debt
(2002: 75% HUF, 25% currency debt)

Increasing debt ratio in 2003

In 2003 public debt increased by HUF 1,364 billion (14.8 per cent) and reached HUF 10,588 billion. The budget deficit increased public debt by HUF 1,054.3 billion, the direct cash injection to the NBH's equalization reserve added HUF 82.9 billion to it, the exchange rate loss on foreign currency debt increased it by HUF 260 billion, and the swell in foreign currency deposits at the end of the year made yet another contribution to the increase of the debt, while privatisation revenues decreased it. Apart from that, the real interest rate, which was higher than the growth rate of the economy, had another unfavourable impact on the debt dynamism. The debt ratio increased from 55.1% to 56.7% on cash basis in 2002.



Concerning financing, **the stock of government securities owned by non-residents has also increased** within the total debt portfolio.

- On 31 December 2003, government securities denominated in HUF, and held by non-residents amounted to HUF 2,223 billion, involving a HUF 429 billion increment for the whole year. This amount represents 34% of marketable government securities, with an average term to maturity of 3.66 years.
- In 2003, the foreign currency debt increased by HUF 312 billion and reached HUF 2,579 billion mainly because of the exchange rate loss affecting the portfolio. This amount represents 24% of

⁵ The debt ratio according ESA95, representing the basis of the Maastricht criteria is somewhat different.

the total debt, with an average term to maturity of 4.8 years.

- In total, the debt held by foreigners increased from 44.1% in 2002 to 45.1%.

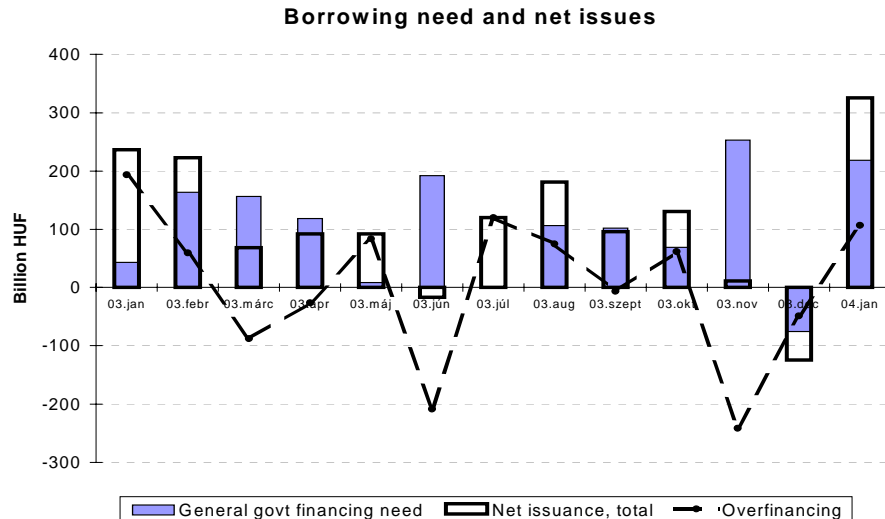
External financing increased because domestic savings turned out to be short compared to the deficit of the budget. This type of financing involves a higher risk because foreign investors react to news more sensitively, which increases the volatility of the yield.

However, there were **favourable changes** in the debt portfolio as well:

- The ratio of foreign currency debt has decreased within public debt portfolio, which reduced the exchange rate risk of the portfolio.
- The share of fixed rate bonds, maturity and average term to maturity have increased in the HUF market, as a result of which interest rate risk and the risk of renewal have declined too.
- Loans under unfavourable terms and conditions have been prepaid.

Falling interest and exchange rate risk

Financing in 2003 was influenced by several unfavourable factors. The net financing demand increased quarter by quarter, yet, owing to adequate demand, financing could be provided with increased issues at auctions. The total net issues in 2003 involved HUF 1,109 billion.

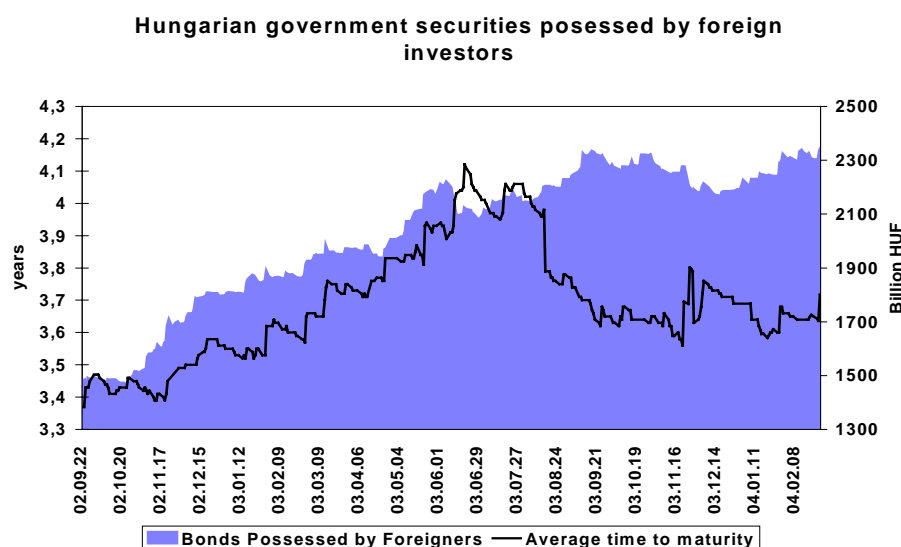


Since the last flash report, the financing conditions of public debt have deteriorated. In January, the market uncertainty related to the developments of the Hungarian economic policy was reflected in a considerable increase in yield. Government securities auctions were held with average interest of investors. In February, the yields continued to increase on the short side, while they stagnated on the long side, with medium or weak demand at government securities auctions. The stability of the government securities market was guaranteed by high participation of foreigners in the market.

Deteriorating financing conditions and “fragile” stability in the first months of 2004

In January, there was an increasing interest, which turned into a significant interest of non-residents in government securities. Last month the majority of issued bonds were purchased by non-residents. In January and February, the total government securities portfolio held by non-residents increased by approximately HUF 140 billion, and by the end of February the portfolio reached HUF 2,360 billion.

Increase of the government securities portfolio of non-residents



Debt management has changed in two areas for the year of 2004. On the one hand, the high HUF yield at the end of 2003 called for an increase in FX financing. Therefore, the total FX issues in 2004 have been increased to EUR 3 billion in order to ease the burden on HUF. Thus, as a temporary diversion from the strategy, in 2004 FX issues will be higher than the amount of maturing FX debt. On the other hand, the tasks of the Debt Management Agency have been extended with the equalisation of Single Treasury Account volatility, for which new instruments have been introduced (liquidity treasury bill, repo, etc.).

Temporarily changing key factors of the debt strategy

The other objectives of ÁKK (Debt Management Agency) including the increase of average term to maturity and duration of HUF debt, increase of the ratio of instruments with a fixed interest rate and obtaining a government securities volume providing a liquid market have not changed.

It is still an important objective of the economic policy to reduce the ratio of debt and budget deficit compared to GDP. The new favourable processes starting in **2004** will probably help to recover the trust of investors, and encourage foreign investors to return to Hungary. As the fundamentals improve, and economic policies are co-ordinated, yields may be reduced as Hungary is integrated into the EU gradually, resulting in a reasonable amount of interest payments. In total, the **financing**

conditions may improve. The temporary increase of FX financing, which is different from the strategy, can also induce the process.

5.3 Households

The receivables of the household sector (gross savings) were similar to the previous years in the first three quarters of 2003 (HUF 708 billion), but its liabilities increased significantly till October (by HUF 838 billion). Thus in the first three quarters of last year the net financing position of the sector was HUF –130 billion forint, i.e., even the household sector had a financing demand. The so-called operational transactions, describing the consumption and accumulation decisions of the households best, indicate the processes even better,⁶ because in the case of these aggregates the increase in financial liabilities exceeded the increase of financial assets of households by nearly HUF 270 billion.

In the first three quarters of 2003 the indebtedness of households amounted to HUF 130 billion

The negative net financing capacity is still the result of a dynamic increase of the loan portfolio. The total loans increased primarily in relation to property loans (HUF 550 billion), but there was also a significant increment in consumption (HUF 120 billion) and other loans too (HUF 175 billion). On the other hand, the reduction in the net position of the household sector was also the result of the trends observed in the previous years (typical of the emerging economies)⁷. Despite a fast increase in household debts, the total debt of the sector represented only 15 per cent of GDP at the end of last year, while the gross savings amounted to 71 per cent of GDP.

The increasing indebtedness is still the result of a dynamic increase in the loan portfolio

Yield changes played a very important role in the structural changes of the financial instruments of the household sector. Because of the high interest rates in the first three quarters of 2003, households increased their HUF deposits significantly, by HUF 250 billion, while the FX deposits declined by HUF 50 billion, which was also due to the exchange rate loss suffered on the weaker USD. Apart from an increase in the HUF deposit portfolio, conservative financial instruments were preferred, which was indicated by the portfolio of stock exchange shares, held by the sector, which declined by HUF 35 billion in this period. At the same time, insurance technical reserves went up by HUF 260 billion. There was a slight decrease in the total government bonds and treasury bills held by the sector, which was the result of the falling prices originating from the yield increase.

On the basis of the processes and data of the fourth quarter,⁸ the household sector became a net saver again following a negative net financing position in the second and third quarters of the year. Its

In the fourth quarter of the year, the sector became a net saver

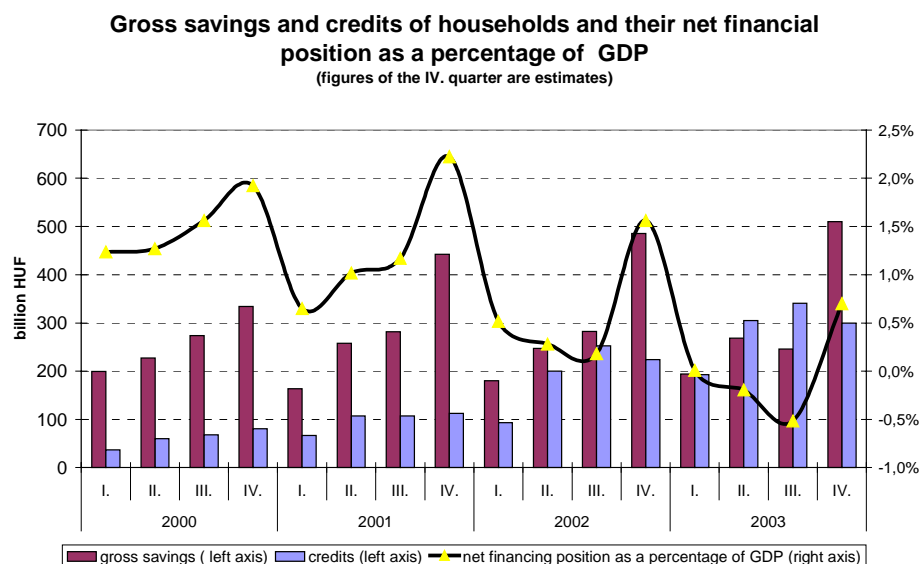
⁶ The operational transaction is the result of the change of portfolio during a given period, without the effects of revaluation due to exchange rate changes, inflation interest compensation and other volume changes.

⁷ A robust increase of the loan portfolio is not unusual in emerging economies. It is specifically true for Hungary where the household debts were very low even in international comparison. In addition, the Hungarian society could be described as a large degree of consumers' impatience and liquidity limitations.

⁸ Actual data are only available for I-III quarters..

estimated net financing position was 0.7 per cent of GDP in the quarter, thus the net financing position of the household sector is expected to be around 0-0.3 per cent of GDP for the whole 2003. The favourable last quarterly data relate to an increase in household income, which was partly the result of seasonal impacts (payment of bonuses and other awards at year end) as well as occasional items (pension for the 53rd week, maternity benefit awarded by the Supreme Court).

again, so its net position for the whole year is expected to be around 0-0.3 of GDP.



According to our expectations, in 2004 the gross household savings will be affected by contrary factors. The falling wage dynamism will reduce household savings, but the prudential motive resulting from unfavourable outlooks and related slow consumption increase indicate a growth. The income increment originating from the high interest rate and increasing stock exchange prices will also result in an increase of savings.

In 2004, the increase in household savings is expected to exceed their debts, so the sector can play a role again in satisfying the financing demand of the national economy.

Concerning the loans, a turn is expected in the indebtedness of the household sector, because due to stricter measures applied for the state subsidy of property loans and high interest rates, the borrowing of the sector is expected to decline in absolute terms too compared to 2003.

As a result of all these factors, the net household position can become positive again, and the sector can play a role again in satisfying the financing demand of the budget and the other sectors of the national economy.

5.4 Corporate sector

According to the accounts of the national economy, in accordance with the economic boom, in 2003 the corporate entities retained their natural net borrower status, regained in the first quarter (corporate sector without credit institutions). In the first three quarters, their borrowing amounted to HUF 456 billion compared to HUF 14.4 billion in the same period of 2002. The financing demand of non-financial companies increased by more than HUF 550 billion as a result of an increase in production and

Significant increase in the funding requirement of corporates in 2003

capital investments.

Development of corporate sector's* position according to the financial accounts (HUF billion)

	2002. Q1	2002. Q2	2002. Q3	2002. Q4	2003. Q1	2003. Q2	2003. Q3
Non-financial corporations	-111,0	116,9	-50,6	309,7	-283,6	-160,1	-109,3
Other financial corporations**	-39,7	10,2	59,7	-36,1	29,8	96,2	-29,0
Total	-150,7	127,2	9,1	273,6	-253,8	-63,9	-138,3

* without credit institutions

** other financial intermediaries+financial auxiliaries+insurance companies, pension funds

On the basis of monetary, balance of payment and securities statistics (because the statement of annual accounts has not been published yet) the total borrowing of the corporate sector amounted to HUF 326 billion in 2003 involving the main channels mentioned above.

Financing of corporates was based on net HUF 849 billion lending from domestic banks. The share of non-financial enterprises of this total was HUF 732 billion. Gross debts increased fastest in other financial enterprises during the year. The borrowing of non-financial enterprises increased by 20%, which was the result of 43 % increase in FX debts. Corporate entities increased their HUF loans, the portfolio of which is more than twice as large as that of FX loans to a much less extent in absolute terms too. In the total net corporate borrowing, the share of FX loans increased by 10%, and reached 74%. The extremely high increase in FX borrowing may be due primarily to the very high Hungarian interest rates.

Increase in the proportion of FX loan in the financing of corporates

In addition to borrowing, corporate entities increased their deposits by approximately 10%, in relation to which the dynamism of FX deposits was also a few per cents higher than that of HUF deposits.

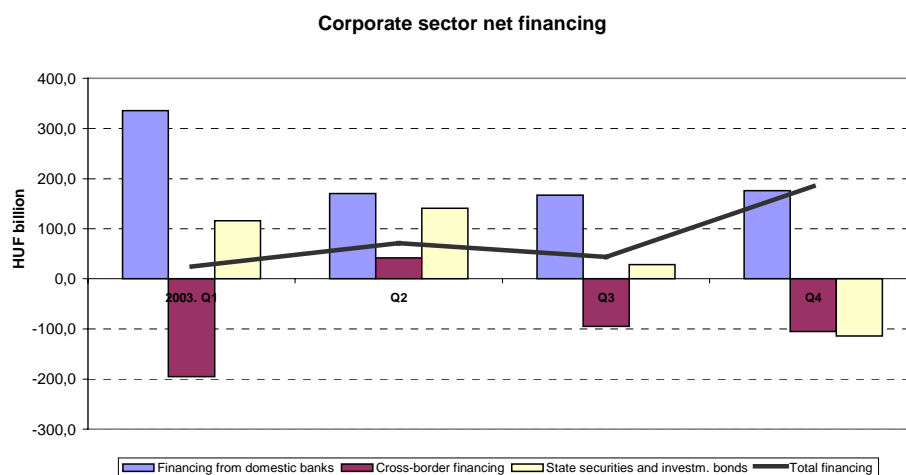
The external funding of corporate entities shrank by HUF 353 billion in 2003 (based on the audited NBH figures for 1st-3rd quarters, and preliminary figures for the 4th quarter). By the end of the year, owners' loans dropped by HUF 465 billion, and as a result of the durable investment outflow in the first and fourth quarters, despite of the increased influx in the second and third quarters the annual volume of the direct investment amounted only to HUF 50 billion. The volume of direct foreign loans taken by corporate entities was HUF 118 billion, representing 14 % of the total FX loans, compared to 15% in the previous year.

Foreign direct investments, which increased in the second and third quarters, reduced in the fourth quarter.

The total **government securities and investment unit portfolio** of the corporate sector increased by HUF 171 billion during the year. The 7% growth achieved by the end of the year was determined by the HUF 256 billion increase in the first half of the year, because due to increasing financing demand, corporate entities reduced their investments in these

Major security portfolio decrease by corporate entities towards the end of the year

two types of securities by more than HUF 110 billion in the last quarter of the year.



Note: The growth of the net financing from the domestic banks and from abroad increase, the growth of the securities stock decreases the total net corporate financing

5.5 External balance⁹

EUR 3.3 billion deficit accumulated in the current account for the first three quarters of the year. However, a turn occurred in the fourth quarter and, following nearly 18 months of deterioration, the deficit declined compared to the base period as a result of improving export performance. Thus, for the whole year, EUR 4.2 billion deficit accumulated, which represents approximately 5.7% of GDP, and which was EUR 1.4 billion (1.7% of GDP) higher than the deficit prevailing in 2002. Clearly different periods occurred during the year, starting with fast deterioration in the first half, followed by deceleration of the deterioration dynamism in the second half, and finally, more favourable trends than in the year 2002 in the last quarter owing to slow improvement of the external boom. The process was also assisted by the base impact, because the country reaches the lowest point in the first half of 2003. The current deficit was also influenced by the fact that the increase of net interest expenses was overcompensated by the lower profit transfer, and thus income transfers were below the transfers made in the base period. Unrequired transfers improved the current balance by EUR half a billion.

The current account deficit is EUR 4.2 billion, approximately 5.7% of GDP. The deteriorating trend, prevailing for nearly 18 months, broke in the fourth quarter

In 2003 the deterioration of the external balance was the consequence of unfavourable processes in the real economy. There was a significant increase in the foreign trade deficit¹⁰. The effective decline of exports in

The foreign trade balance deficit remained below the

⁹ On the basis of preliminary monthly non-adjusted December data of NBH, the current account deficit was approximately EUR 4.58 billion. However, according to foreign trade data published by CSO, significant positive corrections were made in the second half of the year, which were not contained in the current account figures of NBH yet. As a result of the approximately EUR 400 million positive adjustment affecting the export, the foreign trade balance deficit was below EUR 3 billion and the current deficit was EUR 4.2 billion. Our analysis is based on the adjusted data.

¹⁰ The current account value data are expressed in EUR.

the first half of the year was replaced with a stronger export dynamism in the second half of the year. In addition, the import dynamism increased gradually too, and stabilised at a high level in the fourth quarter. However, the role of consumption is decreasing, and that of exports and investments induced by the external boom is increasing in the growth of imports. The import dynamism was higher than that of export, but the export and import growth rate gap has reduced significantly by the end of the year.

expected figure as a result of the intensive increase of exports in the second half

It is a new phenomenon in 2003 that the traditional surplus of services disappeared and a 260 million deficit occurred in 2003. The position of services deteriorated by approximately EUR 900 million. While in 2002 the balance eroded by nearly EUR 1 billion due to a decline in tourism, in 2003, 60% of the deterioration occurred as a result of increasing deficit of other services. During two years, Hungary has lost nearly EUR 2 billion net revenues in services. As a consequence of the worldwide crisis of tourism, which started in September 2001, the surplus of tourism (EUR 1.2 billion) dropped so much in 2003 that it was unable to offset the increasing deficit of other services (EUR -1.5 billion). 12% of tourism revenues were lost (EUR -400 million). As the terrorist risks returned, the improvement that started at the beginning of the year broke in the season again. This is also why the tourist expenses of residents remained around the base figure despite the high household consumption expenses.

The role of services improving the external balance stopped in 2003, and the falling surplus of tourism was unable to offset the increase of deficit of other services any more

The turnover of other services increased with a strong increase of revenues (23.8 %), and much higher dynamism of expenses (28.5%). The advantage of imports has gradually diminished. The deficit amounts to EUR 1.5 billion, which is EUR 500 million higher than in 2002. It is difficult to explain such a turnover increase with only boom factors, while the deterioration of the balance seems to be in line with the high domestic consumption dynamism.

The balance deterioration within other services affected all main service types. The deficit of extremely heterogeneous technical and cultural services increased most

The balance deterioration within other services affected all main service types. The deficit of extremely heterogeneous technical and cultural services increased most.¹¹ This was the result of a decline in know-how and licence fee revenues, and increase in the expenses of computer and information services. However, the increase of rent expenses pointed to the same direction too. The balance improvement occurring from the reduction of other business, professional and technical services was only able to reduce the unfavourable impact of the previous items. It should also be noted that the trading and business services, which were still improving in 2002, produced a deteriorating balance in 2003. The net extra expenditure of trading services occurred as a result of the fact that the increase in expenditure overcompensated the increase of revenues from re-export and other trading services.

The nearly 1.5 billion net income transfers were EUR 200 million lower than in 2002. The EUR 800 million profit transfers of the private sector,

Lower income transfers

¹¹ The detailed analysis is based on the data of the first three quarters of the year. 90% of the balance deterioration in 2003 compared to 2002 occurred during this period.

which suffered from a recession and an increase of wage costs were nearly EUR 300 million lower than in 2002. This position improvement still offset the increase of net interest expenses (EUR 800 million) because the increasing indebtedness and high HUF interest rates had a small affect in 2003 yet.

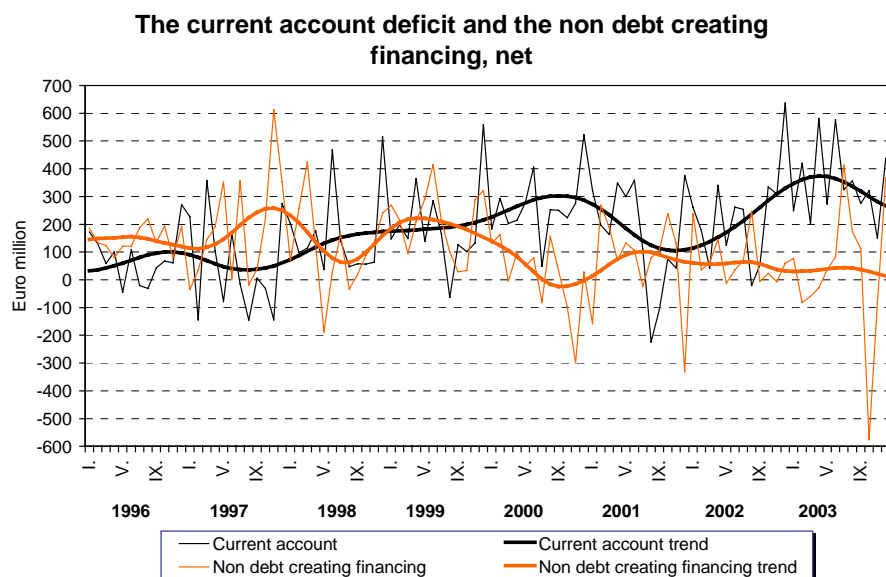
Compared to 2002, the deterioration of external balance, which was extremely drastic in the first half of the year (EUR -1,1 billion) and still continued in the third quarter in relation to the ad hoc outstanding net expenditure of services (EUR -673 million) broke in the fourth quarter mainly as a result of an increase in exports, and an improvement took place (EUR 369 million). It seems that the real economy impulse of external balance deterioration is calming down. The improving external demand may lead to a potential increase in exports and restrictions on the dynamism of domestic consumption may lead to favourable changes in the structure of imports and its relative ratio in 2004. The position of services may also be determined primarily by the external and internal boom. The income transfers may be negatively affected by the increase of the debt stock and higher interest rates, and as boom starts, the probability of an increase in profit transfers may increase. According to our expectations, the external balance of 2004 will be determined by the real economy and its structural improvement, as well as increase of income transfers. In accordance with the new methodology, the accounting of reinvested income will increase the current deficit by approximately 2% of GDP. Compared to 2003, in 2004 this ratio may move towards growth in relation to the EU accession and the increasing boom.

The **financing** structure is unfavourable because of the large current account deficit and an increase in foreign investments of residents in 2003 despite the fact that foreign direct investments in Hungary (EUR 1.5 billion) were higher than in 2002. The capital placement, financing also the regional expansion of Hungarian residents increased to EUR 1.3 billion compared to EUR 200 million in 2002. This is a single outstanding figure, despite the fact that at the current level of Hungary's development we shall estimate a higher figure of capital placements on a long-term basis too. (In the developed countries, the volume of in and outward FDI is nearly identical.) Despite the outflow of end-of-year government securities and HUF market turbulence, EUR 230 million net investments came in through the portfolio channel throughout the whole year, compared to the EUR 190 million outflow in 2002. With the EUR 4.2 billion current account deficit, there was only EUR 438 million non-debt creating capital items. However, we were only able to finance 90% of the external deficit with debt generating liabilities, as a result of which the indebtedness of the national economy and the state has increased. However, the current account deficit and non-debt-creating financing trend indicate an improving tendency, pointing towards a reduction in the current account deficit. However, the trend can only continue if external boom also continues and the domestic consumption dynamism can be withheld. If the external balance improves this way, there is hope for more intensive direct investments through the equity and portfolio

The external balance will be defined by the structural improvement of the real economy and increase in income transfers in 2004

Only 10% of the increased current account deficit was financed by non-debt generating liabilities

channels, as a result of which the indebtedness trend may be broken. If it happens, the indebtedness (as % of GDP) can be reduced gradually, and a long-term structural improvement may start.



The external balance continued to improve in January 2004. The current account deficit was EUR 163 million, involving 37 million decline compared to January 2003. In the trade of goods, the deficit reduced in the net capital income related to debt. The deficit of services continued to increase because of the decline of tourism revenues, which had continued for two years.

Further improvement in the external balance, decline in the trade deficit and net interest expenses

No favourable turns occurred in the non-debt-creating financing. Although capital investments in Hungary increased (close to EUR 100 million), capital investments made by Hungarian residents amounted to more than twice that figure (EUR 205 million), and funds were withdrawn on the portfolio line too. Thus, in summary, compared to the EUR 60 million investments gained in the base period, in January EUR 110 million investments were placed elsewhere.

The significant outflow of investments by Hungarian investors extracted funds from the economy

Budapest, 17 March 2004.

T A B L E S

Table 1.

ECONOMIC INDICATORS
Real Sector, Prices, Competitiveness

change from the same period of the previous year, %

	2000	2001	2002	2003						2004	
	I-IV. quarter	I-IV. quarter	I-IV. quarter	I. month	1 - 2 month	I. quarter	I. half of year	I-III. quarter	I-IV. quarter	I. month	I-IV. quarter
GDP volume 15/	5.2	3.8	3.5	-	-	2.7	2.5	2.7	2,9*	-	-
Household consumption	5.0	5.3	9.4	-	-	7.2	7.2	7.6	-	-	-
Gross fixed capital formation	7.7	3.5	7.2	-	-	-1.2	0.5	2.1	3,1*	-	-
Exports of goods and services	21.0	8.8	3.8	-	-	3.2	2.4	4.2	-	-	-
Imports of goods and services	19.4	6.1	6.1	-	-	5.3	7.5	10.9	-	-	-
Volume of retail trade turnover 14/	2.0	5.4	10.7	12.5	10.4	9.1	8.2	8.5	8.5	-	-
Volume index of investments	6.5	3.5	5.8	-	-	-1.2	0.5	2.1	3,1*	-	-
Foreign trade turnover 1/: export volume	21.7	7.8	6,8 /12	6.5	2.2	2.8	1.9	5.5	8,8*	17,1*	-
import volume	20.8	4.0	6,1 /12	2.2	2.5	4.2	6.5	9.0	10,1*	12,3*	-
Volume of industrial production	18.2	3.6	2.8	6.0	2.5	4.1	4.1	5.0	6.4	7,2*	-
Volume of construction-installation activities	7.6	8.3	17.8	3.6	-10.5	-17.3	-3.9	-1.8	0.7	-	-
Number of employees (in thousands)											
household survey (annual average)	3849.1	3859.5	3870.7	3862.4	3847.5	3859.6	3891.7	3911.9	3921.9	3884.1	-
labour statistics 2/	2718.1	2720.8	2726.1	2711.1	2718.6	2721.2	2737.4	2746.2	2752.8	-	-
Vacancies (in thousands) 3/	39.2	37.3	34.0	31.9	37.7	42.7	50.8	52.7	-	-	-
Number of unemployed (in thousands) 3/	372.0	342.8	344.9	374.3	388.3	386.2	336.2	344.7	359.9	-	-
Rate of unemployment (household survey, %)	6.4	5.7	5.8	6.6	6.5	6.4	6.1	6.0	5.9	6.3	-
Consumer price index	9.8	9.2	5.3	4.7	4.6	4.6	4.3	4.4	4.7	6.6	7.1
Index of industrial domestic sale prices	14.5	9.4	1.6	3.5	4.3	4.4	3.9	4.3	5.0	7.3	-
Index of industrial export sale prices	8.5	1.5	-4.5	-3.1	-2.7	-2.4	-2.0	-0.8	0.3	3.9	-
Agricultural production prices	22.5	4.9	-1.1	6.2	-0.5	0.3	-0.4	3.2	5.3	14.4	-
Competitiveness 10/											
based on manufacturing prices	-5.3	-9.0	-7.9	-6.2	-5.4	-5.2	-3.3	-2.0	-0.9	-	-
based on CPI	-1.6	-7.6	-9.1	-6.4	-5.4	-5.4	-3.9	-2.5	-1.3	-	-
based on ULC (value added)	-2.6	-8.0	-9.6	-	.	-6.4	-4.8	-2.3	.	.	.

Table 2.

ECONOMIC INDICATORS
Income and Monetary Aggregates

		change from the same period of the previous year, %										
		2000	2001	2002	2003						2004	
		I-IV. quarter	I-IV. quarter	I-IV. quarter	1. month	1 - 2 month	I. quarter	I. half of year	I-III. quarter	I-IV. quarter	I. month	I. month
Average earnings:	gross	13.5	18.0	18.3	20.9	17.1	15.2	14.1	13.5	12.0	-	-
	net	11.4	16.2	19.6	23.4	20.7	19.1	18.1	17.0	14.3	-	-
	Household savings (HUF billion)	1049.9	1145.4	1196.8	-	-	193.2	653.2	707.9	-	-	-
	credits (HUF billion)	245.4	391.8	769.9	-	-	196.2	508.8	838.5	-	-	-
General government GFS balance (HUF million) 4/		-480.2	-444.0	-1685.6	-44.4	-208.2	-282.1	-601.1	-809.4	-1054.3	-218.6	-341.3
Central budget GFS balance (HUF billion) 4/		-368.7	-402.9	-1469.6	-12.9	-140.8	-224.1	-458.6	-588.6	-727.9	-173.9	-
primary balance (HUF billion)		329.7	212.7	-832.0	23.3	-31.5	-70.3	-89.5	-69.8	0.6	-141.5	-
revenue change 4/		14.2	10.5	7.1	23.9	14.1	10.0	11.3	12.9	13.0	-11.7	-
expenditure change 4/		13.7	10.4	30.4	10.5	11.3	11.6	13.7	13.4	-3.2	20.7	-
Social Security Funds 5/: balance		-81.4	-28.8	-100.9	-42.1	-87.8	-79.4	-169.4	-256.2	-345.2	-58.8	-
revenue change		10.7	18.6	17.2	13.0	12.8	20.5	16.7	15.1	4.8	4.3	-
expenditure change		12.5	14.9	20.4	23.6	21.9	21.0	16.5	13.0	14.4	10.1	-
Government paper benchmark yields (average annual) 6/												
3 month		11.80	9.80	8.24	6.75	5.48	6.27	7.63	9.41	12.16	12.38	12.71
12 month		11.57	9.21	7.95	6.51	6.20	6.58	8.12	8.87	12.03	12.01	12.58
3 year-bonds		10.74	8.17	7.37	6.88	6.84	6.64	7.86	7.97	10.16	10.29	11.16
5 year-bonds		9.11	7.72	7.00	6.74	6.54	6.74	6.51	7.87	9.27	9.23	9.91
10 year-bonds		9.04	7.06	6.44	6.51	6.42	6.50	6.08	7.22	8.02	8.13	8.75
15 year-bonds		-	6.68	-	6.34	-	6.34	6.51	-	-	-	8.21
Interest rates 6, 7/:												
with maturity less than a year	credit	12.80	11.18	9.7	8.27	7.00	8.23	8.68	10.48	13.39	13.53	-
	deposit	9.50	8.40	7.4	5.47	3.89	5.11	6.57	8.44	10.96	11.06	-
with maturity more than a year	credit	13.40	11.15	9.7	9.54	9.69	9.37	9.53	10.35	13.17	13.92	-
	deposit	9.40	7.70	8.0	5.14	4.67	5.06	6.84	8.60	10.80	11.37	-
Increase of money supply 8/		12.9	17.2	18.9	10.9	13.0	12.9	20.6	19.3	10.1	20.8	-
Current account of balance of payments (mEUR) old methodology		-3152	-1967	-2771	-200	-626	-849	-2378	-3479	-4584*	-	-
Preliminary revised balance 15/		-	-	-	-251	-	-875	-2305	-3264	-4174	-	-
Net foreign debt denominated in foreing currencies (bEUR) old meth.9/		7.0	4.3	4.2	-	-	5.9	6.5	7.2	-	-	-
BUX index 3/		7865	7122	7739	7486	7212	7423	7782	8930	9627	10064	10242

METHODOLOGICAL REMARKS

for Table 1 and 2

Signs: * Preliminary data; . : data is not available yet; - : no data for the period

- 1/ Including industrial customs free zones. The Statistical Office price indexes are published quarterly; the volumes for other periods are calculated with estimated price indexes.
- 2/ Data for firms with more than 5 employees and for budgetary institutions total.
- 3/ End of period data.
- 4/ Excluding privatization receipts. At the general government the interim data do not include the local governments.
- 5/ Total revenues and expenditures of the Pension Fund and Health Fund are not consolidated with the non-self-provided services.
- 6/ The yield or interest in the last month of the period.
- 7/ At deposits with maturity longer than a month but not longer than a year.
- 8/ M3 does not include deposits with an agreed maturity over 2 years and debt securities with over 2 years' agreed maturity issued by monetary financial institutions. However, it includes holdings by residents other than monetary financial institutions of MNB bonds with up to 2 years' agreed maturity plus holdings by residents other than monetary financial institutions of investment units issued by money market funds.
- 9/ Excluding intercompany loans
- 10/ Price based indicators seasonally non-adjusted, unit labour cost based indicators seasonally adjusted
- 11/ As a consequence of correction of short term credits the net foreign debt has changed.
- 12/ There is a change in the statistical methodology from December 2002, therefore the CSO corrected only the annual volume indices.
According to the CSO publication exports went up by 5,9 % while imports increased by 5,1 % in 2002.
- 13/ Without part-time employees
- 14/ Including sales of motor vehicles and automotive fuel
- 15/ Revised data: the correction based on the January-December data of the foreign trade statistics.

Main Indicators of the Hungarian Economy

2001 - 2004

	2001	2002	2003	2004
	fact	prel.fact		expected
	<i>volume change over the previous year, %</i>			
Gross Domestic Product	3.8	3.5	cca. 2,9	3,3 - 3,5
Domestic use of G D P	1.9	5.3	cca. 5,5	cca. 3
of which:household consumption	5.3	9.4	7 - 8	1 - 2
gross fixed capital formation	3.5	7.2	3 - 3,5	6 - 8
Foreign trade turnover (goods and services)				
Export volume change	8.8	3.8	cca. 9	8 - 10
Import volume change	6.1	6.1	cca. 12	8 - 10
	<i>change in percentage of previous year</i>			
Gross average wages	18.0	18.3	12.0	7 - 8
Net average wages	16.2	19.6	14.3	6 - 7
Real wages, per employees	6.4	13.6	9.2	0 - 1
Consumer price index (annual average)	9.2	5.3	4.7	6 - 6,5
	<i>at current prices</i>			
Deficit of foreign trade balance, Euro billion	3.6	3.4	4.3	4 - 4,5
Current account deficit, Euro billion	2.0	2.8	4.2	4 - 4,5
	<i>in percentage of GDP</i>			
Indicators in percentage of GDP:				
ESA95 general government deficit	4.7	9.4	cca. 5,6*	cca. 4,6
Current account deficit	3.4	4.0	cca. 5,7	cca. 5,5

GROWTH RATES AND GROWTH PROJECTIONS ON THE WORLD ECONOMY

Percentage change in real GDP relative to the preceding relevant period

Denomination	2 0 0 1				2 0 0 1	2 0 0 2				2002 (estimate)	2003				2003 (estimate)	2004 (projection)
	Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4		
			(Economist)					(Economist)					(Economist)			
United States	2.5	1.2	0.6	0.5	0.3	1.5	2.2	3.2	2.9	2.4	2.0	3.3	3.6	4.3	3.1	4.7
Japan	-0.1	-0.7	-0.5	-1.9	0.4	-1.6	-0.7	1.3	2.6	0.3	2.6	3.0	1.8	3.6	2.3	2.6
Eurozone	2.5	1.7	1.3	0.6	1.5	0.3	0.7	0.8	1.2	0.8	0.8	0.2	0.3	0.6	0.5	1.8
Germany	1.6	0.6	0.3	-0.1	0.6	-0.2	0.1	0.4	0.5	0.2	0.2	-0.2	-0.2	0.2	-0.1	1.6
France	2.7	2.3	2.0	0.9	1.8	0.7	1.2	1.2	1.7	1.2	1.1	-0.3	-0.3	0.5	0.2	1.9
Italy	2.3	2.0	1.9	0.7	1.8	0.1	0.2	0.5	1.0	0.4	0.8	0.3	0.5	0.1	0.5	1.6
United Kingdom	2.6	2.3	2.1	1.6	1.9	1.0	1.3	1.8	2.1	1.8	2.2	1.8	2.0	2.8	2.1	3.0
Austria	2.2	1.2	0.9	-0.4	1.0	-0.6	0.9	1.2	1.3	1.0	1.0	0.7	0.8	n.a.	0.9	1.8
Poland	2.3	0.9	0.8	0.3	1.1	0.5	0.8	1.6	2.1	1.3	2.2	3.8	3.9	n.a.	3.7	4.8
Czech Republic	3.8	3.9	3.2	3.2	3.1	2.5	2.5	1.5	1.5	2.0	2.2	2.1	3.4	n.a.	2.8	3.3
Russia	4.0	4.0	4.9	4.3	5.0	3.7	4.1	4.3	5.2	4.3	6.8	7.2	5.7	n.a.	6.0	4.1

Source: OECD, EU Commission, IMF, Economist